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S. Hrg. 98-629 Part III

COMPETITIVE EQUITY IN THE FINANCIAL SERVICES INDUSTRY

HEARINGS

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

S. 2181

TO AUTHORIZE DEPOSITORY INSTITUTION HOLDING COMPANIES TO ENGAGE IN ACTIVITIES OF A FINANCIAL NATURE, INSURANCE UNDERWRITING AND BROKERAGE, REAL ESTATE DEVELOPMENT AND BROKERAGE, AND CERTAIN SECURITIES ACTIVITIES INCLUDING DEALING IN, UNDERWRITING AND PURCHASING GOVERNMENT AND MUNICIPAL SECURITIES, SPONSORING AND MANAGING INVESTMENT COMPANIES AND UNDERWRITING THE SECURITIES THEREOF, TO PROVIDE FOR THE SAFE AND SOUND OPERATION OF DEPOSITORY INSTITUTIONS, TO AMEND THE FEDERAL RESERVE ACT, THE HOME OWNERS' LOAN ACT OF 1933, AND THE BANK SERVICE CORPORATION ACT, AND FOR OTHER PURPOSES

S. 2134

TO ESTABLISH THE PERMISSIBLE SCOPE OF POWERS FOR DEPOSITORY INSTITUTIONS AND THEIR HOLDING COMPANIES CONSISTENT WITH THEIR SAFE AND SOUND OPERATIONS, TO SIMPLIFY THE PROCEDURES FOR ENGAGING IN SUCH ACTIVITIES, AND FOR OTHER PURPOSES

PART III

MARCH 6, 7, 13, 21, 27, AND 28, 1984

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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COMPETITIVE EQUITY IN THE FINANCIAL SERVICES INDUSTRY

PART III

TUESDAY, MARCH 6, 1984

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Gorton, Hecht, Humphrey, Proxmire, and Dodd.

OPENING REMARKS OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Ladies and gentlemen, we are pleased today to continue hearings on S. 2181 and S. 2134, the financial institutions deregulation legislation. This is the fifth in a series of hearings and I am pleased to note that last week Congressman St Germain announced that he would hold hearings on the same subject and I certainly think that is a step in the right direction, for both Houses of Congress to be holding hearings on these very important issues.

[Copies of bills S. 2181, S. 2134 and a title-by-title analysis of the Financial Services Competitive Equity Act, S. 2181, follow:]

II

98TH CONGRESS
1ST SESSION

S. 2181

To authorize depository institution holding companies to engage in activities of a financial nature, insurance underwriting and brokerage, real estate development and brokerage, and certain securities activities including dealing in, underwriting and purchasing government and municipal securities, sponsoring and managing investment companies and underwriting the securities thereof, to provide for the safe and sound operation of depository institutions, to amend the Federal Reserve Act, the Home Owners' Loan Act of 1933, and the Bank Service Corporation Act, and for other purposes.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 18 (legislative day, NOVEMBER 14), 1983

Mr. GARN introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To authorize depository institution holding companies to engage in activities of a financial nature, insurance underwriting and brokerage, real estate development and brokerage, and certain securities activities including dealing in, underwriting and purchasing government and municipal securities, sponsoring and managing investment companies and underwriting the securities thereof, to provide for the safe and sound operation of depository institutions, to amend the Federal Reserve Act, the Home Owners' Loan Act of 1933, and the Bank Service Corporation Act, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE OF ACT

SECTION 1. This Act may be cited as the "Financial Services Competitive Equity Act".

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TITLE I—FINANCIAL INSTITUTIONS COMPETITIVE EQUITY

AMENDMENTS TO THE BANKING ACT OF 1933

SEC. 101. (a) Section 20 of the Banking Act of 1933 (12 U.S.C. 377) is amended by inserting the following new paragraph after the first paragraph of such section:

"Notwithstanding any other provision of this section, a member bank may be affiliated in any manner described in section 2(b) with a depository institution securities affiliate as defined in section 2(j) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(j)).".

(b) Section 32 of the Banking Act of 1933 (12 U.S.C. 78) is amended by inserting the following sentence at the end of the first paragraph of such section: "Notwithstanding any other provision of this section, an officer, director, or employee of any member bank may serve at the same time as an officer, director, or employee of any of its depository institution securities affiliates. The term 'depository institution securities affiliate' shall have the meaning ascribed to it in section 2(j) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(j)).".

AMENDMENTS TO THE SECURITIES ACT OF 1933

SEC. 102. Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended adding at the end thereof the following:

"(7) Transactions involving offers or sales of equity securities, in connection with the acquisition of a bank by a company under the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.), or in connection with the acquisition of an insured institution by a company under the Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a), if such acquisition occurs solely as part of a reorganization in which a person or group of persons exchange their shares of a bank or insured institution for shares of a newly formed bank holding company or savings and loan holding company and receive, after such reorganization, substantially the same proportional share interests in the holding company as they held in the bank or insured institution, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under State law.".

AMENDMENTS TO THE SECURITIES EXCHANGE ACT

SEC. 103. (a) Subparagraphs (i), (ii), and (iii) of paragraph (34)(A) of subsection 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(34)(A)) are each amended by inserting immediately before the semicolons at the end thereof the following: "other than a depository institution securities affiliate as defined in section 2(j) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(j)) or as defined in section 408(a)(1)(K) of the National Housing Act (12 U.S.C. 1730a(a)(1)(K))".

(b) Section 15B(b)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-4(b)(1)) is amended by striking out "subsidiaries" in subparagraphs (B) and (C) and inserting in lieu thereof "affiliates".

AMENDMENTS TO THE BANK HOLDING COMPANY ACT

SEC. 104. (a) Section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841) is amended—

(1) by amending subsection (c) to read as follows:

"(c) 'Bank' means (1) an 'insured bank' as defined in section 3(h) of the Federal Deposit Insurance Act; or (2) any institution organized under the laws of the United States, any State of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands, that accepts deposits that the depositor may withdraw by check or similar means for payment to third parties and is engaged in the business of making commercial loans. The term 'bank' does not include (A) any foreign bank having an insured branch; (B) an insured institution; (C) any organization operating under section 25 or section 25(a) of the Federal Reserve Act; (D) any organization that does not do business in the United States except as an incident to its activities outside the United States; or (E) any consumer bank as defined in subsection (k) of this section or any industrial bank, Morris Plan bank, industrial loan company or similar institution, operated in the manner authorized by State law, that does not both engage in the business of making commercial loans and accept deposits that the depositor has a legal right to withdraw on demand."; and

(2) by inserting after subsection (i) the following new subsections:

"(j) The term 'depository institution securities affiliate' means any corporation that (1) is engaged in the United States in one or more of the activities authorized pursuant to section 4(c)(15) of this Act, and (2) is a broker or dealer within the meaning of paragraph (4) or (5) of section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)), or an investment adviser within the meaning of section 202(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(11)). For purposes of this Act, a corporation engaged in any such activities shall be deemed to be a depository institution securities affiliate only so long as it is a bank holding company or is owned or controlled by a bank holding company.

"(k) The term 'consumer bank' means any institution that would otherwise be a 'bank' under subsection (c) of this section but that does not engage in the business of making commercial loans.

"(l) the term 'commercial loans' does not include (1) loans to natural persons primarily for personal, family, or household purposes, whether directly, indirectly or through the use of leases; (2) loans for charitable persons; (3) loans secured by residential real property; (4) loans to natural persons through use of credit cards or similar means of access; or (5) investments such as commercial paper, certificates of deposit, bankers acceptances and similar money market instruments, the extension of broker call loans, the sale of Federal funds, the deposit of interest-bearing funds, mortgage-backed securities, obligations of the United States and local and State governments, or agencies and instrumentalities thereof, and such other similar types of investments as may be permitted by the institution's primary regulator. An institution shall not be deemed to 'engage in the business of making commercial loans' if the aggregate principal amount of its outstanding commercial loans represented by (A) credit to finance the inventorying of goods generally being acquired by natural persons; (B) loans to small business concerns; and (C) similar loans, does not exceed 5 percent of the institution's total assets.

"(m) For purposes of this Act—

"(1) the term 'depository institution holding company' means a bank holding company;

"(2) the term 'depository institution' means bank; and

"(3) the terms 'savings and loan holding company' and 'insured institution' have the meanings ascribed to them in section 408(a)(1) of the National Housing Act.".

(b) Section 3 of the Bank Holding Company Act of 1956 (12 U.S.C. 1842) is amended—

(1) by inserting before the period at the end of the second sentence of subsection (a) the following: "; or (C) with thirty days prior notification to the Board, the acquisition by a company of control of a bank in a reorganization in which a person or group of persons exchange their shares of the bank for shares of a newly formed bank holding company and receive, after such reorganization, substantially the same proportional share interest in the holding company as they held in the bank except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under State law if, immediately following such acquisition, the bank holding company meets the capital and other financial standards prescribed by the Board by regulation for such a bank holding company and the holding company does not engage in any activities other than those of banking or managing and controlling banks. In promulgating regulations pursuant to this subsection, the Board shall not require more capi-

tal for the subsidiary bank immediately following the reorganization that is required for a similarly sized bank that is not a subsidiary of a bank holding company."; and

(2) by adding at the end thereof the following:

"(f) No company may acquire, directly or indirectly, any voting shares of, interest in, or substantially all of the assets of any additional consumer bank located outside of the State in which the operations of such company's consumer bank subsidiaries were principally conducted on July 1, 1983, unless—

"(1) the acquisition of such shares or assets of a consumer bank in such State by a company controlling a consumer bank in another State is specifically authorized by the statute laws of the State in which such consumer bank is located, by language to that effect and not merely by implication;

"(2) the acquisition of shares or assets of a bank in such State by a bank holding company is specifically authorized by the statute laws of the State in which such bank is located, by language to that effect and not merely by implication; or

"(3) the acquisition of such shares or assets of an industrial bank, Morris Plan bank, industrial loan company, or similar institution by a company is authorized by the statute laws of the State in which such institution is located, by language to that effect and not merely by implication.

For the purpose of this section, the State in which the operations of a company's consumer bank subsidiaries are principally conducted is that State in which total deposits of all such consumer bank subsidiaries are largest.".

(c) Section 4(a)(2) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(a)(2)) is amended—

(1) by striking out subparagraph (B) and inserting in lieu thereof the following: "(B) those permitted under paragraphs (8) (except for those of an insured institution), (15), and (16) of subsection (c) of this section subject to all the conditions and requirements specified in each respective paragraph or in any order or regulation issued by the Board under such paragraphs"; and

(2) by adding at the end thereof the following: "The two-year period referred to in this paragraph shall not apply to a company that becomes a bank holding company as a result of enactment of the Financial Services Competitive Equity Act and that acquired a bank between July 1, 1983, and the effective date of such Act. A company that becomes a bank holding company as a result of the enactment of the Financial Services Competitive Equity Act, and that controlled

an insured bank on July 1, 1983, may engage in any activity in which it was lawfully engaged, directly or through a subsidiary, on July 1, 1983, and in which it has been engaged continuously since July 1, 1983. The authority conferred by the preceding sentence (i) shall terminate at such time as (I) any covered bank holding company acquires control of an additional bank or an insured institution, (II) its existing subsidiary bank commences accepting deposits that the depositor has a legal right to withdraw on demand and engages in the business of making commercial loans, or (III) any covered bank holding company commences, directly or through a subsidiary, after July 1, 1983, any additional activities, other than those activities authorized pursuant to this act (except for the acquisition of an insured institution), in which it was not engaged on July 1, 1983; and (ii) may be terminated by the Board by order, after opportunity for hearing, if it determines, having due regard to the purposes of this chapter, that such action is necessary to prevent conflicts of interests or unsound banking practices or is in the public interest. Any activities authorized for bank holding companies may not be expanded and any additional activities may not be commenced except in accordance with the requirements, conditions, and limitations applicable to bank holding companies.".

(d) Paragraph 8 of subsection 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 843(c)) is amended to read as follows:

"(8)(A) in accordance with the limitations and requirements contained in subparagraphs (B) and (C) of this paragraph, shares of any insured institution, shares of a consumer bank, or shares of any company the activities of which consist of—

"(i) activities that the Board has determined (by order or regulation) to be closely related to banking or managing or controlling banks or (by regulation) to be of a financial nature;

"(ii) insurance underwriting or brokerage; or

"(iii) real estate investment, development or brokerage: *Provided,* That, in the case of real estate investment and development, the percentage of a bank holding company's capital that may be devoted to this activity shall not exceed 5 per centum of such company's primary capital, except that for purposes of this clause, real estate investment and development shall include, but not be limited to, the acquisition, management, and maintenance of developed or undeveloped real estate, but shall not include any form of construction activity.

"(B)(i) No bank holding company shall engage in any activity authorized under this paragraph either de novo or by an acquisition in whole or in part of a going concern, unless the Board has been given sixty days prior written notice of such proposal and, within such period, the Board has not issued an order (I) disapproving the proposal, or (II) suspending the time period in accordance with clause (iii) below.

"(ii) An acquisition may be made prior to the expiration of the disapproval period if the Board issues a written notice of its intent not to disapprove the action. The Board may provide for no notice under this paragraph or notice for a shorter period of time with respect to particular activities. No notice under this paragraph is required in the event a bank holding company establishes de novo an office to engage in any activity previously authorized for such a bank holding company under this paragraph or changes the location of an office engaged in such activity.

"(iii) The notice submitted to the Board shall contain such information as the Board shall prescribe by regulation or by specific request in connection with a particular notice: *Provided, however,* That the Board may only require such information as may be relevant to the nature and scope of the proposed activity and to the Board's evaluation of the criteria provided for in clause (iv) hereof. In the event the Board requires additional relevant information beyond that provided in the notice submitted pursuant to this paragraph, the Board may by order suspend the time period provided in clause (i) hereof until it has received such additional relevant information, and the activity that is the subject of the notice may be commenced within thirty days of the date of such receipt unless the Board issues a disapproval order as provided in clause (i) hereof. Such a suspension order is reviewable under section 9 of this Act.

"(iv) In connection with a notice under this paragraph, the Board may consider the following criteria—

"(I) the managerial resources of the companies involved;

"(II) the adequacy of their financial resources, including their capital, giving consideration to the financial resources and capital of others engaged in similar activities: *Provided,* That the Board shall not require a higher level of capital for any activity subject to Federal or State regulation than would be required by the applicable regulatory authority for a company engaged in such activity, unless the Board shall find that particular circumstances warrant a higher level of capital;

"(III) any practice or arrangement that may adversely affect the independence or impartiality of an affiliated bank in the provision of credit or other services or the terms on which such credit and services are made available, or the availability of such credit;

"(IV) any material adverse effect on the safety and soundness or financial condition of an affiliated bank or banks; and

"(V) with respect to an acquisition subject to subparagraph (i) or (ii) of paragraph (8)(c), compliance with such subparagraph.

"(v) The Board shall by order set forth the reasons for any disapproval under this paragraph. Inaction on any notice or a Board order determining not to disapprove a proposal to engage in an activity that has previously been authorized by regulation under this paragraph shall be final and shall not be subject to judicial review under this Act or in any other manner: *Provided, however,* That any bank holding company may obtain judicial review pursuant to section 9 of this

Act of any Board order not to disapprove a notice under this paragraph if such order contains restrictions or conditions.

"(vi) The Board shall, within one hundred and eighty days of enactment of the Financial Services Competitive Equity Act and from time to time thereafter, promulgate regulations under this paragraph designating particular activities that are closely related to banking or of a financial nature. A bank holding company may petition the Board to determine by regulation that a particular activity is closely related to banking or of a financial nature. The Board may by regulation prescribe limitations on the conduct of any activity or activities authorized under paragraphs (8), (15), and (16) of this subsection consistent with the criteria in subparagraph (B)(iv) hereof and with safe and sound financial practices. In administering this paragraph, the Board shall promote competition between bank holding companies and all other companies engaged in activities of a financial nature or closely related to banking.

"(vii) The regulation required under clause (vi) of this paragraph shall include any activity determined by the Board by regulation prior to enactment of this Act to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. The

Board shall not designate as an activity of a financial nature or closely related to banking within the meaning of this paragraph any activity that is described in paragraph (15) of this subsection or that is prohibited to a member bank or an affiliate of a member bank under sections 16 (12 U.S.C. 24 (Seventh)) or 20 (12 U.S.C. 377) of the Banking Act of 1933.

"(C)(i) No bank holding company that owns or controls one or more banks with consolidated deposits in the United States equal to or exceeding 0.30 per centum of all domestic deposits in the United States shall acquire, merge, or consolidate with, or purchase the assets of, a company engaged in insurance, securities, real estate or other activities permissible under paragraph (8) or (15) of this section hereof if, immediately after and as a result of such acquisition, such bank holding company shall have an investment in any one such activity that exceeds 25 per centum of the consolidated capital of such bank holding company.

"(ii) No company that is engaged in an activity otherwise permissible for bank holding companies under paragraph (8) or (15) of this section shall acquire, merge, or consolidate with, or purchase the assets of, a bank or banks with consolidated deposits in the United States equal to or exceeding 0.30 per centum of all domestic deposits in the United States, if, immediately after and as a result of such acquisition, such company shall have an investment in any one such activity that exceeds 25 per centum of the consolidated capital of such company.

"(D)(i) Notwithstanding any other provision of this paragraph, an acquisition involving direct or indirect control of an insured institution by a bank holding company (except an acquisition resulting from a transaction authorized under section 13(f) of the Federal Deposit Insurance Act or section 408(m) of the National Housing Act) shall be subject to the restrictions of section 3(d) hereof, as if the insured institution were a bank.

"(ii) Except for a branch or branches resulting from an acquisition under section 408(m) of the National Housing Act, any insured institution that becomes a subsidiary of a bank holding company may retain and operate its existing branch or branches, but otherwise its branches shall be subject to locations where a national bank may establish and operate branches in the State in which such insured branch is located.".

(e) Section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)) is amended—

(1) by striking out the penultimate sentence thereof;

(2) by striking out the period at the end thereof and inserting in lieu thereof a semicolon; and

(3) by adding at the end thereof the following:

"(15) shares of any depository institution securities affiliate engaged in activities in accordance with the limitations contained in this paragraph:

"(i) No depository institution holding company that establishes or acquires any depository institution securities affiliate pursuant to this paragraph shall, after one year from the date on which any such depository institution securities affiliate first engages in any of the activities authorized under subparagraph (iii) of this paragraph, permit any depository institution contolled by such depository institution holding company to engage, directly or through a subsidiary, in the United States in any of the activities authorized under such subparagraph (iii) of this paragraph or any of the following activities, which are authorized pursuant to paragraph Seventh of section 5136 of the Revised Statutes of the United States, as amended (12 U.S.C. 24): dealing in and underwriting obligations of the United States, general obligations of any State of the United States or any political subdivision thereof and other obligations listed in paragraph Seventh of such section 5136 and purchasing and selling securities and stock as agent. For purposes of this paragraph, the Board may, by regulation or order, determine other securities or securities-related activities in which depository institutions may not engage. No rule, regulation or order of the Board, however, shall prohibit a depository institution from engaging in those securities or securities-related activities that are necessary or incidental to the financing of such depository institution or the investment of its funds. In the event that a depository institution holding company terminates all of the activities specified in subparagraph (iii) of this paragraph of its depository institution securities affiliate, any depository institution subsidiary of such holding company may conduct, directly or through a subsidiary, any securities or securities-related activities that it is authorized by law to conduct.

"(ii) Any depository institution securities affiliate may conduct any securities or securities-related activity that a national banking association, as such term is used in section 21 of this title, is not prohibited from conducting.

"(iii) In addition to the activities referred to in subparagraphs (i) and (ii) of this paragraph, such depository institution securities affiliate may—

"(I) deal in and underwrite all obligations issued or guaranteed by or on behalf of a State or any political subdivision thereof or any agency or instrumentality of either of the foregoing, except industrial development bonds as defined in section 103(b)(2) of the Internal Revenue Code of 1954, as amended: *Provided, however,* That depository institution securities affiliates may deal in and underwrite such industrial development bonds, the interest on which is exempt from Federal income tax under section 103(a) of the Internal Revenue Code of 1954, as amended, if: (i) a State, territory, possession of the United States, or any political subdivision of the foregoing, or the District of Columbia pledges its full faith and credit for the payment of all principal and interest on such bonds or (ii) the issuer, or the State or local governmental unit on behalf of which the industrial development bonds were issued, is considered the sole owner, for Federal income tax purposes, of the facility with respect to which financing is to be provided from the proceeds of such industrial development bonds;

"(II) organize, sponsor, operate, and control an investment company, as such term is defined in section 3 of the Investment Company Act of 1940, as amended;

"(III) render investment advice to: (1) an investment company as described in subparagraph (B) above; and any investment company other than a closed-end investment company;

"(IV) underwrite, distribute, and sell securities of any investment company, as such terms are defined in section 3 of the Investment Company Act of 1940; and

"(V) deal in and underwrite promissory notes secured by real estate mortgages and participation interests in such notes or mortgage related payment bonds secured by such notes or participation interests. For purposes of this subparagraph, a mortgage related payment bond means an obligation (which may be with or without recourse to the issuer thereof) which, by its terms, provides for payments of principal in relation to payments, or reasonable projections of payments, on notes meeting the above requirements or participation interests therein which are pledged as security for such obligation and which are rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization.

"(iv) A bank holding company seeking to acquire shares of a depository institution securities affiliate or engage directly in securities or securities-related activities pursuant to this paragraph shall comply with the notice and other requirements of clauses (i) through (vi) of paragraph (8)(B) of this subsection; or".

(f) Section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)) is amended by adding at the end thereof the following:

"(16) shares of any company engaged in any activity in which a multiple savings and loan holding company was authorized by law or regulation to engage directly on July 1, 1983: *Provided, however,* That the activities of real estate investment and development may only be engaged in within the limitations of clause (iii) of section 4(c)(8)(A) of this Act: *And provided further,* That any conditions and limitations applicable to a savings and loan company with respect to such activities shall likewise be applicable to such a bank holding company, except that a bank holding company seeking to acquire shares of such a company pursuant to this paragraph shall comply with the notice and other requirements of clauses (i) through (vi) of paragraph (8)(B) of this subsection and except that the Board may by regulation prohibit any bank holding company from engaging in such activities or limit their conduct.".

(g) Section 5(c) of the Bank Holding Company Act (12 U.S.C. 1844(c)) is amended to read as follows:

"(c)(1) The Board from time to time may require reports under oath, in such scope and detail as it may determine, of a bank holding company and each subsidiary thereof to keep the Board informed as to whether such companies are complying with the provisions of this chapter and regulations and orders issued thereunder.

"(2) Except where the Board determines that a lesser reporting requirement is appropriate, the Board shall accept in fulfillment of the reporting requirements established by this subsection for nonbank subsidiaries separate reports consisting of (A) for companies subject to the reporting requirements of section 17 of the Securities Exchange Act of 1934 (15 U.S.C. 78q), the same information required to be submitted to the Securities and Exchange Commission under such section (and the rules and regulations thereunder) at the same time such information is so submitted; and (B) for all other companies, the same information as would be required to be submitted under section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) (and the rules and regulations thereunder) by companies subject to the reporting requirements of such Act, that are engaged in the same or similar lines of business, not more frequently than quarterly. In particular circumstances, the Board may require additional information in order to fulfill its responsibilities under this Act.

"(3) The Board may make examinations of each bank holding company and each subsidiary thereof, the cost of which may be assessed against, and paid by, such holding company. The Board shall, however, insofar as possible, minimize the scope and frequency of examinations of nonbank subsidiaries of a bank holding company by utilizing, where feasible, reports of applicable regulatory agencies or other bodies public or private, and by directing, to the extent feasible, the focus of such examinations to the activities or financial condition of such nonbank subsidiaries that may have a materially adverse effect on the safety and soundness or financial condition of a subsidiary bank of the bank holding company.".

(h) Section 7 of the Bank Holding Company Act of 1956 (12 U.S.C. 1846) is amended by striking out the period at the end thereof and inserting in lieu thereof ", except that (1) no State may prohibit the affiliation of a national banking association, as such term is used in section 21 of this title, with a company engaged only in one or more of the activities described in paragraphs (8), (15), and (16) of subsection 4(c) of this Act, and (2) no State may authorize banks which it charters to engage in insurance activities outside such State on a basis different from that authorized for such banks within the State.".

AMENDMENT TO THE FEDERAL RESERVE ACT

SEC. 105. (a) The Federal Reserve Act is amended by inserting after section 23A the following:

SEC. 23B. RESTRICTIONS ON TRANSACTIONS WITH AFFILIATES.—(a) A member bank and its subsidiaries may engage in any of the following transactions, only on terms and under circumstances, including credit standards, that are substantially the same as, or at least as favorable to such bank or its subsidiary as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies or, in the absence of comparable transactions, those terms and circumstances that in good faith would be offered to, or would apply to nonaffiliated companies—

"(1) any covered transaction, as defined in section 23A, with an affiliate;

"(2) the sale of securities or other assets, including assets subject to an agreement to repurchase, to an affiliate;

"(3) the payment of money or the furnishing of services to an affiliate, under contract, a lease, or otherwise;

"(4) any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person; or

"(5) any transaction or series of transactions with a third party, (A) if an affiliate has a financial interest in the third party, or (B) if an affiliate is a participant in such transaction or series of transactions.

For the purposes of this subsection, any transaction by a member bank with any person shall be deemed to be a transaction with an affiliate of such bank to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, such affiliate.

"(b) A member bank and the affiliates of such bank shall not publish any advertisement or enter into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates; however, a member bank and its affiliates may use similar names.

"(c) A member bank and any subsidiary of such bank—

"(1) shall not purchase as fiduciary any securities or other assets from any affiliate unless such purchases are permitted under the instrument creating the fiduciary relationship, by court order, or by law of the jurisdiction under which the trust is administered; and

"(2) whether acting as principal or fiduciary, shall not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security a principal underwriter of which is an affiliate of such bank; except that this prohibition shall not apply where the purchase of such securities has been approved, prior to the time at which such securities are initially offered for sale to the public, by a majority of the directors of the bank who are not officers or employees of the bank or any affiliate thereof.

For the purpose of this paragraph, the term 'security' means a 'security' as defined in section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)); and the term 'principal underwriter' means any underwriter who, in connection with a primary distribution of securities, (A) is in privity of contract with the issuer or an affiliated person of the issuer; (B) acting alone or in concert with one or more persons, initiates or directs the formation of an underwriting syndicate; or (C) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

"(d) For the purpose of this section—

"(1) the term 'affiliate' means an 'affiliate' as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371C) excluding a bank, and

"(2) the terms 'bank', 'subsidiary', 'person', and 'security' (other than security as used in subsection (c)) have the same meaning given to them in section 23A of the Federal Reserve Act (12 U.S.C. 371c).".

"(e) The Board may prescribe rules and regulations to administer and carry out the purposes of this section, including rules or regulations to (1) further define terms used in this section; (2) exempt transactions or relationships from the requirements of this section; or (3) exclude from the definition of 'affiliate' in this section any subsidiary of a bank holding company, if the Board finds such exemptions or exclusions to be in the public interest and consistent with purposes of this section.".

(b) Section 18(j) of the Federal Deposit Insurance Act (12 U.S.C. 1828(j) is hereby amended—

(1) by inserting "and section 23B" after "section 23A" at each place it appears in paragraph (1); and

(2) by inserting ", 23B," after "23A" in paragraph (3)(A).

AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

SEC. 106. (a) Section 17(f) of the Investment Company Act of 1940 (15 U.S.C. 80a–17(f)) is amended by inserting after "unit investment trusts" the following: ": *Provided, however,* That any registered management company which is organized, sponsored, operated, or controlled by, or which receives investment advice from, any depository institution securities affiliate, as defined in section 2(j) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(j)) or in section 408(a)(1)(K) of the National Housing Act (12 U.S.C. 1730a(a)(1)(K)), may place and maintain its securities and similar investments in the custody of a bank which is affiliated with such depository institution securities affiliate only with the prior approval of the Commission".

(b) Section 26(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a–26(a)(1)) is amended by inserting after "so published);" the following: ": *Provided, however,* That, except with the prior approval of the Commission, it shall be unlawful for such trust indenture, agreement of custodianship, or other instrument to designate as trustee or custodian any bank which is affiliated with a depository institution securities affiliate, as defined in the Bank Holding Company

Act of 1956 (12 U.S.C. 1841(j)) or in section 408(a)(1)(K) of the National Housing Act (12 U.S.C. 1730a(a)(1)(K)), which organizes, sponsors, operates or controls such registered unit investment trust".

(c) Section 27(c)(2) of the Investment Company Act of 1940 (15 U.S.C. 80–27(c)(2)) is amended by inserting after "trust indentures of unit investment trusts" the following: ": *Provided, however*, That, except with the prior approval of the Commission, it shall be unlawful to deposit such proceeds with any bank which is affiliated with a depository institution securities affiliate, as defined in section 2(j) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(j)) or in section 408(a)(1)(K) of the National Housing Act (12 U.S.C. 1730a(a)(1)(K)), which organizes, sponsors, operates, controls or renders investment advice to such registered investment company".

AMENDMENTS TO BANK HOLDING COMPANY ACT AMENDMENTS OF 1970

SEC. 107. Section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1971 et seq.) is amended—

(1) by redesignating subsections (c) through (h) as subsections (d) through (i), respectively; and

(2) by inserting after subsection (b) the following:

"(c) A bank shall—

"(1) explain in writing to a person who solicits credit with reference to which insurance is or may be required that such insurance may be purchased from an insurer or agent of such person's choice, and shall not directly or indirectly solicit such insurance until it has given such person a commitment in writing that the credit solicited shall be extended;

"(2) not unreasonably reject a contract of insurance furnished by a borrower for the protection of the property securing the credit or lien, and shall not reject such a contract without giving the borrower a statement in writing stating the reasons therefor, nor shall it require that any borrower, mortgagor, purchaser, insurer, broker, or agent pay a separate charge in connection with the handling of any contract of insurance required as security for a loan, or pay a separate charge to substitute the insurance policy of one insurer for that of another, nor shall it require any procedures or conditions of duly licensed agents, brokers, or insurers not customarily required of those agents, brokers, or insurers affiliated or in any way connected with the bank;

"(3) not use or disclose, without the prior written consent of the borrower, mortgagor, or purchaser obtained at a time other than the making of the loan or extension of credit, information relative to a contract of insurance which is required by the credit transaction, for the purpose of replacing such insurance;

"(4)(A) accept, with regard to any insurance issued or sold by it or an affiliate thereof, in connection with an extension of credit made by such bank, the cancellation by a borrower of any such insurance if notified by the borrower within 30 days of the effective date of the insurance; and

"(B) refund the unearned portion of the premium to the creditor within twenty days after receipt of a notice of cancellation if no liability for a loss under the insurance has been incurred."; and

(3) by adding at the end of subsection (b)(2) the following:

"(I) Any action for injunctive relief that may be commenced by any person pursuant to subsection (g) may be commenced on behalf of such person by any trade association of which such person is a member. Any such action commenced by a trade association shall be subject to the same requirements, limitations, and conditions as would be applicable had such action been commenced by any such person pursuant to subsection (g).".

AMENDMENTS TO THE NATIONAL HOUSING ACT

SEC. 108. (a) Section 408(a)(1) of the National Housing Act (12 U.S.C. 1730a(a)(1)) is amended—

(1) by amending subparagraph (A) to read as follows:

"(A) 'insured institution' means a Federal savings and loan association, a Federal savings bank, a building and loan, savings and loan or homestead association, or a cooperative bank, the accounts of which are insured by the Federal Savings and Loan Insurance Corporation, and shall include a Federal savings bank or a stock savings bank, the deposits of which are insured by the Federal Deposit Insurance Corporation;";

(2) by amending subparagraph (B) to read as follows:

"(B) 'uninsured institution' means any association or bank referred to in subparagraph (A), the accounts of which are not insured by the Federal Savings and Loan Insurance Corporation, except for a Federal savings bank or stock savings bank, the deposits of which are insured by the Federal Deposit Insurance Corporation; and"; and

(3) by adding at the end thereof the following:

"(K) 'depository institution securities affiliate' means any corporation that (i) is engaged in the United

States in one or more of the activities authorized for depository institution securities affiliates pursuant to section 4(c)(15) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)(15)) and subject to the limitations specified therein, and (ii) is a broker or dealer within the meaning of paragraph (4) or (5) of section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)), or an investment adviser within the meaning of section 202(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(11)). For purposes of this title, a corporation engaged in any such activities shall be deemed to be a depository institution securities affiliate only so long as it is owned or controlled by a savings and loan holding company. For purposes of applying section 4(c)(15) of the Bank Holding Company Act to this title—

"(i) the term 'depository institution holding company' means savings and loan holding company; and

"(ii) the term 'depository institution' means 'insured institution'.

"(L) 'bank holding company' and 'bank' shall have the meanings ascribed to them in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841).".

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(b) Section 408(c) of the National Housing Act (12 U.S.C. 1730a(c)) is amended to read as follows:

"(c)(1) Except as otherwise provided in this subsection, no savings and loan holding company (except a unitary savings and loan holding company that acquires an insured institution pursuant to subsection (m) of this section) or subsidiary thereof which is not an insured institution shall—

"(A) for or on behalf of such subsidiary insured institution, engage in any activity or render any service for the purposes or with the effect of evading law or regulation applicable to such insured institution; or

"(B) commence or continue, after two years from the date as of which it becomes a savings and loan holding company, any business activity other than those specified in paragraph (2) of this subsection except that such two-year period shall not apply to any company that acquires an insured institution between July 1, 1983, and the effective date of the Financial Services Competitive Equity Act: *Provided,* That any company that becomes subject, as a result of the Financial Services Competitive Equity Act, to the prohibitions of this subparagraph and that controlled an insured institution prior to July 1, 1983, may engage in any activity in which it was lawfully engaged, directly or through a subsidiary, on July 1, 1983, and in which it has been engaged continuously since July 1, 1983: *Provided*, That any activities authorized for savings and loan holding companies may not be expanded and any additional activities may not be commenced except in accordance with the requirements, conditions, and limitations applicable to savings and loan holding companies. The authority conferred by the preceding proviso, (A) shall terminate at such time as any covered savings and loan holding company (i) acquires a bank, or its subsidiary insured institution fails to qualify as a domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code of 1954, or (ii) commences, directly or through a subsidiary, after July 1, 1983, any additional activities, other than those authorized pursuant to this Act to be permissible for savings and loan holding companies (except for the acquisition of a bank), in which it was not engaged on July 1, 1983, or (B) may be terminated by the Corporation, after opportunity for hearing, if it determines, having due regard for the purposes of this chapter, that such action is necessary to prevent conflicts of interests, unsound practices, or in the public interest.

"(2) The prohibitions of subparagraph (1)(B) of this subsection shall not apply to the following business activities—

"(A) furnishing or performing management services for a subsidiary insured institution;

"(B) conducting an insurance agency or escrow business;

"(C) holding or managing or liquidating assets owned or acquired from a subsidiary insured institution;

"(D) holding or managing properties used or occupied by a subsidiary insured institution;

"(E) acting as trustee under deed of trust;

"(F) acquiring shares of any bank and engaging in one or more of the following activities subject to the limitations, conditions, and requirements specified in paragraph (3) of this subsection: (i) activities determined by the Board of Governors of the Federal Reserve System (by regulation) to be of a financial nature or closely related to banking or managing or controlling banks: *Provided, however,* That the Corporation may (by regulation) prohibit or limit any such activity for savings and loan holding companies; (ii) activities in which multiple savings and loan holding companies were authorized (by regulation) to engage directly on July 1, 1983: *Provided, however,* That in the case of real estate investment and development, savings and loan holding companies may only maintain investments lawfully held on July 1, 1983, and make additional investments within the limitations of clause (iv) hereof; (iii) engaging in either or both the activities of insurance underwriting and brokerage; (iv) engaging in one or more of the activities of real estate investment, development, or brokerage: *Provided*, That, in the case of real estate investment and development, the percentage of a savings and loan holding company's capital that may be devoted to this activity shall not exceed 5 per centum of such company's primary capital, except that for purposes of this clause, real estate investment and development shall include, but not be limited to acquisition, management, and maintenance of developed or undeveloped real estate, but shall not include any form of construction activity; and (v) engaging in the activities of a depository institution securities affiliate in accordance with the terms under which such activity may be conducted pursuant to the provisions of paragraph (15) of section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)), except that notwithstanding any other provision of this subparagraph, an acquisition involving the direct or indirect control of a bank by a savings and loan holding company (except an acquisition resulting from a transaction authorized under section 13(f) of the Federal Deposit Insurance Act) shall be subject to the restrictions of section 3(d) of the Bank Holding Company Act of 1956, as if any insured institution subsidiary of the savings and loan holding company were a bank and as if the savings and loan holding company were a bank holding company; and

"(G) acquiring shares of any company which is an export trading company, as that term is defined in paragraph (14) of section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)), and subject to all the requirements, conditions, and limitations of such paragraph (14) as if the acquiring or establishing savings and loan holding company were a bank holding company within the meaning of that paragraph, except that any notice required to be given pursuant to that paragraph shall be given to the Corporation, which shall have the same authority with respect to such notice procedure for savings and loan holding companies as the Board of Governors of the Federal Reserve System has pursuant to such paragraph (14).

"(3)(A) No savings and loan holding company shall engage, either de novo or by an acquisition, in whole or in part, of a going concern, in any activity authorized under paragraph (2)(F) of this subsection unless the Corporation has been given sixty days' prior written notice of such proposal and, within such period, the Corporation has not issued an order disapproving the proposal or extending for up to an additional thirty days the period within which such a disapproval may be issued.

"(B) An acquisition may be made prior to the expiration of the disapproval period if the Corporation issues a written notice of its intent not to disapprove the action. The Corporation may provide for no notice under this paragraph or notice for a shorter period of time with respect to particular activities. No notice under this paragraph is required in the event a savings and loan holding company establishes de novo an office to engage in any activity previously authorized for such savings and loan holding company under this paragraph or changes the location of an office engaged in such activity.

"(C) The notice submitted to the Corporation shall contain such information as the Corporation shall prescribe by regulation for the notice or by specific request in connection with a particular notice: *Provided, however,* That the Corporation may only require such information as may be relevant to the nature and scope of the proposed activity and to the Corporation's evaluation of the criteria provided for in subparagraph (D) hereof. In the event the Corporation requires additional relevant information beyond that provided in the notice submitted pursuant to this paragraph, the Corporation may by order suspend the time period provided in subparagraph (A) of this paragraph until it has received such additional relevant information, and the activity that is the subject of the notice may be commenced within thirty days of the date of such receipt unless the Corporation issues a disapproval order as provided in such subparagraph (A). Such suspension order is reviewable under subsection (k) of this section.

"(D) In connection with a notice under this paragraph, the Corporation may consider the following criteria—

"(i) the managerial resources of the companies involved;

"(ii) the adequacy of their financial resources, including their capital, giving consideration to the financial resources and capital of others engaged in similar activities: *Provided,* That the Corporation shall not require a higher level of capital for any activity subject to Federal or State regulation than would be required by an applicable regulatory authority for a company engaged in such activity, unless the Corporation shall find that particular circumstances warrant a higher level of capital;

"(iii) any practice or arrangement that may adversely affect the independence or impartiality of an affiliated insured institution in the provision of credit or other services or the terms on which such credit and services are made available, or the availability of such credit;

"(iv) any material adverse effect on the safety and soundness or financial condition of an affiliated insured institution; and

"(v) with respect to an acquisition subject to paragraph (2) (F) or (G), compliance with such paragraph.

"(E) The Corporation shall by order set forth the reasons for any disapproval under this paragraph. Inaction on any notice or a Corporation order determining not to disapprove a proposal to engage in an activity that has previously been authorized by regulation under this paragraph shall be final and shall not be subject to judicial review under this section or in any other manner: *Provided, however,* That any savings and loan holding company may obtain judicial review pursuant to this section of any Corporation order not to disapprove a notice under this paragraph if such order contains restrictions or conditions.

"(F) The Corporation may by regulation prescribe limitations on the conduct of any activity or activities authorized under paragraph (2)(F) of this subsection other than limitations on activities conducted pursuant to clause (v) thereof, consistent with the criteria in subparagraph (D) hereof and with safe and sound financial practices.

"(G)(i) No savings and loan holding company that owns or controls an insured institution or insured institutions with consolidated deposits in the United States equal to or exceeding 0.30 per centum of all domestic deposits in the United States shall acquire, merge, or consolidate with, or purchase the assets of, a company engaged in insurance, securities, real estate or other activities permissible under paragraph (2)(F) of this paragraph, if immediately after and as a result of such acquisition, such savings and loan holding company shall have an investment in any one such activity that exceeds 25 per centum of the consolidated capital of such savings and loan holding company.

"(ii) No company that is engaged in any activity otherwise permissible for savings and loan holding companies under paragraph (2)(F) of this paragraph shall acquire, merge, or consolidate with, or purchase the assets of, a bank or banks with consolidated deposits in the United States equal to or exceeding 0.30 per centum of all domestic deposits in the United States if, immediately after and as a result of such acquisition, such company shall have an investment in any one such activity that exceeds 25 per centum of the consolidated capital of such company.

"(4)(A) Notwithstanding any other provision of this subsection, any savings and loan holding company (including any subsidiary thereof which is not an insured institution) the sole insured institution subsidiary of which is a qualified thrift lender shall not be subject to the limitations and prohibitions of this subsection: *Provided, however,* That nothing in this paragraph shall exempt a bank holding company or its subsidiaries or affiliates from the provisions of the Bank Holding Company Act.

"(B) A qualified thrift lender is any insured institution that, as determined by the Corporation—

"(i) has an aggregate of not more than 25 per centum of its assets (including loans made by any subsidiary of such institution) invested in commercial loans, nonresidential real estate loans, tangible personal property leased for commercial purposes, and floorplanning or inventory loans, and does not thereafter exceed such percentage on an average basis in three out of every four quarters and two out of every three years; or

"(ii) has an aggregate of not less than 60 per centum of its assets (including investments made by any subsidiary of such an institution) invested in loans, equity positions or securities related to domestic residential real estate or manufactured housing and property used by an institution in the conduct of its business, and does not thereafter fall below such percentage on an average basis in three out of every four quarters and two out of every three years.

"(C) Any insured institution that fails to maintain its status as a qualified thrift lender, as determined by the Corporation, may not thereafter be a qualified thrift lender for a period of 5 years. For good cause shown, the Corporation may allow any company that controls such an institution, up to three years to comply with the investment and activities restrictions contained in this subsection.

"(D) The Corporation may issue such rules or regulations, and conduct such examinations, as it determines to be necessary to carry out the provisions of this paragraph, and may enforce with respect to any qualified thrift lender: *Provided,* That with respect to a stock savings bank insured by the Federal Deposit Insurance Corporation, the Corporation shall rely to the maximum extent possible on examinations conducted by that agency.".

(c) Section 408(d) of the National Housing Act (12 U.S.C. 1730a(d)) is hereby amended as follows:

(1) The introductory phrase is amended to read as follows:

"(d)(1) Except as otherwise provided in this section, no subsidiary insured institution of a savings and loan holding company shall—";

(2) Numbers (1), (2), (3), (4), (5), and (6) shall be redesignated as (A), (B), (C), (D), (E), and (F), respectively, and letters (A), (B), and (C) shall be redesignated as (i), (ii), and (iii); and

(3) The following subsection (d)(2) shall be added at the end thereof:

"(2) The prohibitions of subsection (d)(1) shall not apply to the transactions of any subsidiary insured institution of a savings and loan holding company with an affiliate engaged in the business activites specified in subparagraphs (F) and (G) or subsection (c)(2) of this section except for clause (ii) of subparagraph (F); unless the context otherwise requires, such transactions by an insured institution shall be subject to the same limitations and prohibitions specified in sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371 c and d) as if such insured institution were a member bank. The Corporation may prescribe rules or regulations for purposes of defining and clarifying the applicability of the limitations and prohibitions described in the preceding sentence.".

"(d) Section 408 (e) of the National Housing Act (12 U.S.C. 1730a(e)) is amended by striking out clause (ii) of subparagraph (1)(B) and inserting in lieu thereof the following:

"(ii) acquired in connection with a reorganization in which a person or group of persons exchange their shares of an insured institution for shares of a newly formed holding company and receive, after such reorganization, substantially the same proportional share interest in the holding company as they held in the insured institution, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under State law.".

"(e) Section 408(n) of the National Housing Act (12 U.S.C. 1730a) is amended to read as follows:

"(n) No State shall prohibit the affiliation of an association, as that term is defined in section 2 of the Home Owners' Loan Act of 1933, with a company engaged solely in one or more of the activities described in subparagraphs (F) and (G) of subsection (c)(2) of this section.".

AMENDMENTS TO THE HOME OWNERS' LOAN ACT OF 1933

SEC. 109. (a) Section 5(c) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(c)) is amended by amending subparagraph (B) of paragraph (4) to read as follows:

"(B) SERVICE CORPORATIONS.—Investments in any 'depository institution service corporation', as that term is defined in the Depository Institution Service Corporation Act (12 U.S.C. 1861, et seq.) and in accordance with the requirements, conditions, and limitations specified in that Act: *Provided*, That any association that is a qualified thrift lender, as defined in section 408 of the Natonal Housing Act, may make investments in capital stock, obligations, or other securities of any corporation organized under the laws of the State in which the home office of the association is located, if the entire capital stock of such corporation is available for purchase only by savings and loan associations of such State and by Federal associations having their home offices in such State, but no association may make any investment under this subparagraph if its aggregate outstanding investment under this subparagraph would exceed 3 per centum of the assets of the association, except that not less than one-half of the investment permitted under this subparagraph which exceeds 1 per centum of assets shall be used primarily for community, inner city, and community developent purposes.".

(b) Section 5(q) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(q)) is amended by adding at the end thereof the following:

"(6) Any action for injunctive relief that may be commenced by any person pursuant to paragraph (2) of this provision, may be commenced on the behalf of such person by any trade association of which such person is a member: *Pro-*

vided, That any such action commenced by a trade association shall be subject to the same requirements, limitations and conditions as would be applicable had such action been commenced by any such person pursuant to paragraph (2) of this provision."

BANK SERVICE CORPORATION ACT

SEC. 110. The Bank Service Corporation Act (12 U.S.C. 1861 et seq.) is amended to read as follows:

"SHORT TITLE AND DEFINITIONS

"SECTION 1. (a) This Act may be cited as the Depository Institution Service Corporation Act.

"(b) For purposes of this Act—

"(1) the term 'appropriate Federal supervisory agency' shall include 'appropriate Federal banking agency' as defined in section 1813(q) of this title (12 U.S.C. 1813(q)) and the Federal Home Loan Bank Board with respect to any 'insured institution' as defined in section 1730a(a)(1)(A) of this title (12 U.S.C. 1730a(a)(1)(A)) other than a qualified thrift lender as defined in section 408 of the National Housing Act;

"(2) the term 'Depository Institution Service Corporation' means a corporation organized to perform services authorized by this Act, all of the capital stock of which is owned by one or more depository institutions;

"(3) the term 'depository institution' means any institution subject to examination and supervision by any 'appropriate Federal supervisory agency';

"(4) the term 'invest' includes any advance of funds to a Depository Institution Service Corporation, whether by the purchase of stock, the making of a loan, or otherwise, except a payment for rent earned, goods sold and delivered, or services rendered prior to the making of such payment; and

"(5) the term 'principal investor' means the depository institution that has the largest dollar amount invested in the capital stock of a Depository Institution Service Corporation. In any case where two or more depository institutions have equal dollar amounts invested in a Depository Institution Service Corporation, the corporation shall, prior to commencing operations, select one of the depository institutions as its principal investor and shall notify the depository institution's appropriate Federal supervisory agency of that choice within five business days of its selection.

"AMOUNT OF INVESTMENT IN DEPOSITORY INSTITUTION SERVICE CORPORATION

"SEC. 2. Notwithstanding any limitation or prohibition otherwise imposed by any provision of law exclusively relating to any depository institution, a depository institution may invest not more than 10 per centum of paid-in and unimpaired capital and unimpaired surplus in Depository Institution Service Corporations. No depository institution shall invest more than 5 per centum of its total assets in Depository Institution Service Corporations.

"PERMISSIBLE DEPOSITORY INSTITUTION SERVICE CORPORATION ACTIVITIES FOR DEPOSITORY INSTITUTIONS

"SEC. 3. A depository institution may invest in one or more Depository Institution Service Corporations that perform, and a Depository Institution Service Corporation may perform, the following services only for depository institutions and credit unions: check and deposit sorting and posting; computation and posting of interest and other credits and charges; preparation and mailing of checks, statements, notices and similar items; credit information, appraising, construction loan inspection, and abstracting; developing and administering personnel benefit programs; research, studies, and surveys; purchasing office supplies, furniture and equipment; developing and operating storage facilities for microfilm or other duplicate records; and clerical, bookkeeping, accounting, statistical, data processing, internal auditing, and similar functions performed for a depository institution.

"SERVICES TO NONSTOCKHOLDERS

"SEC. 4. No Depository Institution Service Corporation shall unreasonably discriminate in the provision of any services authorized under this Act to any depository institution that does not own stock in the service corporation on the basis of the fact that the nonstockholding institution is in competition with an institution service that owns stock in the depository institution corporation, except that—

"(1) it shall not be considered unreasonable discrimination for a Depository Institution Service Corporation to provide services to a nonstockholding institution only at a price that fully reflects all of the costs of offering those services, including the cost of capital and a reasonable return thereon; and

"(2) a Depository Institution Service Corporation may refuse to provide services to a nonstockholding institution if comparable services are available from another source at competitive overall costs, or if the providing of services would be beyond the practical capacity of the service corporation.

"REGULATION AND EXAMINATION OF DEPOSITORY INSTITUTION SERVICE CORPORATIONS

"SEC. 5. (a) A Depository Institution Service Corporation shall be subject to examination and regulation by the appropriate Federal supervisory agency of its principal investor to the same extent as its principal investor. The appropriate Federal supervisory agency of the principal shareholder of such a Depository Institution Service Corporation may authorize any other Federal supervisory agency that supervises any other shareholder of the Depository Institution Service Corporation to make such an examination.

"(b) A Depository Institution Service Corporation shall be subject to the provisions of the Financial Institutions Supervisory Act of 1966 as if such service corporation were the same type of depository institution as its principal investor, except that the appropriate Federal supervisory agency of the principal investor shall be authorized to apply such provisions to a Depository Institution Service Corporation.

"(c) Notwithstanding subsection (a) of this section, whenever a depository institution that is regularly examined by an appropriate Federal supervisory agency, or any subsidiary or affiliate of such a depository institution that is subject to examination by that agency, causes to be performed for itself, by contract or otherwise, any services authorized under this Act, whether on or off its premises—

"(1) such performance shall be subject to regulation and examination by such agency to the same extent as if such services were being performed by the depository institution itself on its own premises, and

"(2) the depository institution shall notify such agency of the existence of the service relationship within thirty days after the making of such service contract or the performance of the service, whichever occurs first.

"(d) The appropriate Federal supervisory agencies are authorized to issue such regulations and orders as may be necessary to enable them to administer and to carry out the purposes of this Act and to prevent evasions thereof.

"GRANDFATHER RIGHTS

"SEC. 6. (a) Notwithstanding any other provision of law—

"(1) any service corporation owned by one or more depository institutions and acquired or maintained and operated pursuant to the Bank Service Corporation Act of 1982 (12 U.S.C. 1861 et seq. (1982, repealed 1983)) or pursuant to subparagraph (B)(4) of section 5(c) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(c)(B)(4)) and any regulations promulgated thereunder, may engage in those activities in which (i) it was lawfully engaged on July 1, 1983, and (ii) it has been engaged continuously since July 1, 1983; and

"(2) any depository institution that (i) lawfully invested in a service corporation within the meaning of paragraph (1) of this subsection as of July 1, 1983, and (ii) continuously maintained an investment in such a service corporation since July 1, 1983, may maintain and increase such investment, provided that any such investment is made and maintained in accordance with all conditions, requirements, and limitations applicable thereto under the laws described in paragraph (1) of this subsection.

"(b) The authority conferred by subsection (a) of this section shall terminate, with respect to any covered service corporation, at such time as such service corporation expands its activities to include any new activity, or, with respect to any covered depository institution with an investment in such a service corporation, at such time as such depository institution invests in excess of the limitations set forth in subsection (a)(2) of this section in any service corporation: *Provided*, That any appropriate Federal supervisory agency may, upon application by a service corporation or depository institution that would be required to terminate activities of or divest stockownership in a service corporation, authorize such service corporation or depository institution to maintain its activities or stock interest for an appropriate period of time in the public interest, but in no event shall such time period exceed one year.

"MUTUAL THRIFT SERVICE CORPORATIONS

"SEC. 7. Notwithstanding any other provision of law, any association, which is organized and continues to operate in the mutual form, is authorized to invest in the capital stock, obligations, or other securities of any corporation organized under the laws of the State in which the home office of the mutual organization is located, if the entire capital stock of such corporation is available for purchase only by savings and loan associations of such State and by Federal associations having their home offices in such State, but no mutual organization may make any investment under this section if its aggregate outstanding investment under this section would exceed 3 per centum of the assets of the mutual organization, except that not less than one-half of the investment permitted under this section shall be used primarily for community, inner city, and community development purposes. This section shall be interpreted under the Home Owners' Loan Act of 1933, and regulations lawfully promulgated thereunder as of July 1, 1983.".

TITLE II—CREDIT UNION AMENDMENTS

SECOND MORTGAGE LOANS

SEC. 201. Section 107(5)(A)(ii) of the Federal Credit Union Act (12 U.S.C. 1757(5)(A)(ii)) is amended by inserting after "maturity not to exceed fifteen years" the following: "or any longer term which the Board may choose to allow".

MEMBERSHIP SHARES

SEC. 202. Section 107(6) of the Federal Credit Union Act (12 U.S.C. 1757)(6)) is amended to read as follows:

"(6) to receive from its members, from other credit unions, from an officer, employee, or agent of those nonmember units of Federal, Indian, Tribal, State, or local governments and political subdivisions thereof enumerated in section 207 of this Act and in the manner so prescribed, from the Central Liquidity Facility, and from nonmembers in the case of low-income members (as defined by the Board) funds for credit deposit accounts and payments on (A) shares which may be issued at varying dividend rates; (B) share certificates which may be issued at varying dividend rates and maturities; (C) share draft accounts authorized under section 205(f); and (D) membership shares; subject to such terms, rates, and conditions as may be established by the board of directors, within limitations prescribed by the Board.".

FAITHFUL PERFORMANCE

SEC. 203. Section 112 of the Federal Credit Union Act (12 U.S.C. 1761a) is amended by striking out the third sentence and inserting in lieu thereof the following: "The board shall elect from their number a financial officer who shall give adequate fidelity coverage in accordance with section 122 of this Act.".

MEMBERSHIP OFFICER

Sec. 204. Section 113 of the Federal Credit Union Act (12 U.S.C. 1761b) is amended by striking out "of the board of directors" in paragraph (1) and inserting in lieu thereof "of the credit union.".

POWERS OF THE BOARD OF DIRECTORS

Sec. 205. Section 113 of the Federal Credit Union Act (12 U.S.C. 1761b) is amended—

(1) by striking out paragraph (2) and inserting in lieu thereof the following:

"(2) provide adequate fidelity coverage for officers and employees having custody of or handling funds according to regulations issued by the Board;";

(2) by striking out paragraph (7) and inserting in lieu thereof the following:

"(7) determine whether a membership share will be established, the maximum number of shares, share certificates, and share draft accounts and the classes of shares, share certificates, and share draft accounts;";

(5) by striking out paragraph (11) and inserting in lieu thereof the following:

"(11) establish the par value of the membership share (if any) and the share;" and

(6) by striking out paragraph (18) and inserting in lieu thereof the following:

"(18) declare the dividend rate to be paid on shares, share certificates, share draft accounts, and membership shares pursuant to the terms and conditions of section 117;".

NONPARTICIPATION IN THE CREDIT UNION

SEC. 206. Section 118 of the Federal Credit Union Act (12 U.S.C. 1764) is amended—

(1) by striking out "subject to" in subsection (a) and inserting in lieu thereof "except as provided in"; and

(2) by inserting "and enforce" after "adopt" in Subsection (b).

CHANGE IN INSURANCE STATUS

SEC. 207. Section 206(d)(2) of the Federal Credit Union Act (12 U.S.C. 1786(d)(2)) is amended to read as follows:

"(2) No credit union shall convert from status as an insured credit union under this Act as provided under subsection (a)(2) of this section until the proposition for such conversion has been approved by a majority of all the directors of the credit union and by affirmative vote of a majority of the members of the credit union who vote on the proposition. Following approval by the directors, written notice of the proposition and of the date set for the membership vote shall be delivered in person to each member, or mailed to each member at the address for such member appearing on the records of the credit union, not more than thirty nor less than seven days prior to such date. The written notice of the proposition shall in boldface type state that the issue will be decided by a majority of the members who vote. The membership shall be given the opportunity to vote by mail ballot. If the proposition is approved by the membership, prompt and reasonable notice of insurance conversion shall be given to all members.".

TITLE III--BANKERS BANKS

AMENDMENT TO SECTION 5136 OF THE REVISED STATUTES

SEC. 301. The paragraph numbered "Seventh" of section 5136 of the Revised Statutes (12 U.S.C. 24 (Seventh)) is amended by striking out "*Provided further,* That" and all that follows through the end thereof and inserting in lieu thereof the following: "*Provided further,* That notwithstanding any other provision of this paragraph, the association may purchase for its own account shares of stock of a bank or a holding company which owns or controls such a bank if (1) the stock of such bank or company is owned exclusively (except to the extent directors' qualifying shares are required by law) by depository institutions, and (2) such bank or company and all subsidiaries thereof are engaged exclusively in providing services for depository institutions, their parent holding companies, subsidiaries thereof, and the officers, directors, and employees of each. In no event shall the total amount of stock held by the association in any bank or holding company described in the immediately preceding proviso exceed at any time 10 per centum of the association's capital stock and paid-in and unimpaired surplus and in no event shall the purchase of such stock result in an association's acquiring more than 5 per centum of any class of voting securities of such bank or company.".

AMENDMENT TO SECTION 5169 OF THE REVISED STATUTES

SEC. 302. Section 5169(b)(1) of the Revised Statutes (12 U.S.C. 27(b)(1)) is amended to read as follows:

"(b)(1) The Comptroller of the Currency may also issue a certificate of authority to commence the business of banking pursuant to this section to a national banking association if (A) such association or its parent holding company is owned exclusively (except to the extent directors' qualifying shares are required by law) by depository institutions, and (B) the association, its parent holding company, and all subsidiaries thereof are organized to engage exclusively in providing services for depository institutions, their parent holding companies, subsidiaries thereof, and the officers, directors, and employees of each.".

AMENDMENTS TO THE DEPOSITORY INSTITUTION MANAGEMENT INTERLOCKS ACT

SEC. 303. (a) Section 202(3) of the Depository Institution Management Interlocks Act (12 U.S.C. 3201(3)) is amended—

(1) by striking out "; or" after paragraph (C) and inserting in lieu thereof a period; and

(2) by striking out paragraphs (D) and (E).

(b) Section 205(6) of the Depository Institution Management Interlocks Act (12 U.S.C. 3204(6)) is amended to read as follows:

"(6) A Federal Home Loan Bank or any bank or the parent holding company thereof organized specifically to serve depository institutions, their parent holding companies, subsidiaries thereof, and the officers, directors, and employees of each.".

AMENDMENTS TO THE BANK HOLDING COMPANY ACT OF 1956

SEC. 304. (a) Section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)) is amended by inserting after the first sentence thereof the following: "The term 'bank' also includes a State chartered bank or a national banking association if (1) such bank or its parent holding company is owned exclusively (except to the extent directors' qualifying shares are required by law) by depository institutions, and (2) such bank, its parent holding company, and all subsidiaries thereof are organized to engage exclusively in providing services for depository institutions, their parent holding companies, subsidiaries thereof, and the officers, directors, and employees of each.".

(b) Section 4(c)(14)(F) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)(14)(F)) is amended—

(1) by striking the period after clause (i) and inserting in lieu thereof a semicolon;

(2) by inserting "and" after clause (ii);

(3) by striking out clause (iii) and inserting in lieu thereof the following:

"(iii) notwithstanding any other provision of law, the term 'bank holding company' shall include a bank if (1) such bank or its parent holding company is owned primarily by depository institutions, and (2) such bank, its parent holding company, and all subsidiaries thereof are organized to engage exclusively (except as provided in this paragraph) in providing services for depository institutions, their parent holding companies, subsidiaries thereof, and the officers, directors, and employees of each. No depository institution, owning stock in a bank or a holding company described in this clause which invests in an export trading company, shall extend credit to an export trading company in an amount exceeding at any one time 10 per centum of such depository institution's capital and surplus."; and

(4) by striking out clause (iv).

TITLE IV—COMPETITIVE SAVINGS INCENTIVE

SHORT TITLE

SEC. 401. This title shall be referred to as the "Competitive Savings Incentive Act of 1983".

MONEY MARKET DEPOSIT ACCOUNTS

SEC. 402. Section 19(c) of the Federal Reserve Act (12 U.S.C. 461) is amended by adding at the end thereof the following new paragraph:

"(3) Notwithstanding any other provision of law, reserves held by—

"(A) any bank, savings and loan association or mutual or stock savings bank against accounts authorized by section 327 of the Garn-St Germain Depository Institutions Act of 1982 and regulations promulgated thereunder or transaction accounts authorized after December 1, 1982, pursuant to section 327 of the Garn-St Germain Depository Institutions Act of 1982 or sections 203 and 204 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (12 U.S.C. 3502 and 3503); or

"(B) any insured credit union against any comparable accounts authorized by section 117 of title I of the Federal Credit Union Act (12 U.S.C. 1763) and regulations promulgated thereunder,

may be in the form of vault cash, or as deposits in an Earnings Participation Account at a Federal Reserve Bank which shall receive earnings to be paid each month at the rate earned on the securities portfolio of the Federal Reserve System during that month. The earnings on such portfolio shall be passed through on a prorated basis to the depository institutions which maintain reserves pursuant to this paragraph. The Board may prescribe rules and regulations concerning the maintenance and administration of Earnings Participation Accounts under this paragraph.".

TITLE V—CONSUMER LEASES AND RENTAL-PURCHASE AGREEMENTS

SHORT TITLE

SEC. 501. This title may be cited as the "Consumer Lease and Rental-Purchase Agreement Act".

AMENDMENT TO THE CONSUMER CREDIT PROTECTION ACT

SEC. 502. The Consumer Credit Protection Act is amended by adding at the end thereof the following new title:

"TITLE X—CONSUMER LEASE AND RENTAL-PURCHASE ACT

"Chap. Sec.
"1. General Provisions 101
"2. Consumer Leases and Rental-Purchase Agreements 111
"3. Enforcement and Liability 121
"4. Miscellaneous 131

"CHAPTER 1—GENERAL PROVISIONS

"Sec.
"101. Short title.
"102. Findings and declaration of purpose.
"103. Definitions and rules of construction.
"104. Exempted transactions.
"105. Regulations.

"CHAPTER 2—CONSUMER LEASES AND RENTAL-PURCHASE AGREEMENTS

"Sec.
"111. General requirements of disclosure.
"112. Consumer lease disclosures.
"113. Consumer's liability at early termination or at the end of the lease term.
"114. Rental-purchase disclosures.
"115. Renegotiations and extensions.
"116. Consumer lease advertising.
"117. Rental-purchase advertising.

"CHAPTER 3—ENFORCEMENT AND LIABILITY

"Sec.
"121. Administrative enforcement.
"122. Civil liability.
"123. Defenses.
"124. Liability of assignees.
"125. Criminal liability.

"CHAPTER 4—MISCELLANEOUS

"Sec.
"131. Relation to State laws.
"132. Effect on governmental agencies.
"133. Reports by Board and Attorney General.
"134. Effective date.

"TITLE X—CONSUMER LEASE AND RENTAL-PURCHASE ACT

"CHAPTER 1—GENERAL PROVISIONS

"§ 101. Short title

"This title may be cited as the 'Consumer Lease and Rental-Purchase Act'.

"§ 102. Findings and declaration of purpose

"(a) The Congress finds that the leasing of consumer goods continues to be a popular alternative to installment credit purchases. It is the purpose of this title to assure a more meaningful disclosure of the terms of leases of personal property for personal, family or household purposes, permitting the consumer to compare more readily the various lease terms available; to limit the potential balloon payment in consumer leases to a reasonable amount; and to assure accurate disclosures of lease terms in advertising.

"(b) The Congress also finds that a significant number of consumers have begun to acquire ownership of personal property through rental-purchase agreements. These rental-purchase agreements have been offered without adequate cost disclosures. It is the purpose of this statute to assure meaningful disclosure of the terms of rental-purchase agreements; to make the consumer aware of the total cost of the agreement; to inform the consumer when ownership will transfer; and to assure accurate disclosures of rental terms in advertising.

"§ 103. Definitions and rules of construction

"(a) The following definitions apply to this title:

"(1) 'Advertisement' means a commercial message in any medium that aids, promotes, or assists directly or indirectly a consumer lease or a rental-purchase agreement.

"(2) 'Agricultural purposes' includes the production, harvest, exhibition, marketing, transportation, processing, and manufacture of agricultural products by a natural person who cultivates, plants, propagates, or nurtures those agricultural products, including but no limited to the acquisition of farmlands, real property with a farm residence, and personal property and ser ices used primarily in farming.

"(3) 'Board' refers to the Board of Governors of the Federal Reserve System.

"(4) 'Consumer' means a natural person who leases personal property under a consumer lease or rents personal property under a rental-purchase agreement.

"(5) 'Consumer lease' means a contract in the form of a lease or bailment for the use of personal property, and the purchase of services incidental thereto, by a natural person primarily for personal, family, or household purposes, for a period exceeding four months, in which the total lease cost is not more than $25,000, whether or not the consumer has the option to purchase or otherwise become the owner of the property at the expiration of the lease. The term does not include any 'credit sale' as defined in title I.

"(6) 'Consummation' means the time a consumer becomes contractually obligated on a consumer lease or rental-purchase agreement.

"(7) 'Lessor' means a person who regularly provides the use of property through consumer leases or rental-purchase agreements and to whom the obligation is initially payable on the face of the lease or rental-purchase agreement.

"(8) 'Personal property' means any property that is not real property under the laws of the State where it is located when it is made available for a consumer lease or a rental-purchase agreement.

"(9) 'Rental-purchase agreement' means an agreement for the use of personal property by a natural person primarily for personal, family, or household purposes, for an initial perod of four months or less (whether or not there is any obligation beyond the initial period) that is automatically renewable with each payment and that permits the consumer to become the owner of the property. The term does not include any 'credit sale' as defined in title I.

"(10) 'Residual value' means the wholesale or retail fair market value of the leased property at early termination or the end of the lease term in a consumer lease.

"(11) 'State' refers to any State, the Commonwealth of Puerto Rico, the District of Columbia, and any territory or possession of the United States.

"(b) Unless the context indicates otherwise, the term 'lease' means consumer lease, and the term 'agreement' means rental-purchase agreement.

"(c) Any reference to any provisions of this title includes reference to the regulations of the Board under this title.

"§ 104. Exempted transactions

"This title does not apply to the following:

"(1) Consumer leases and rental-purchase agreements primarily for business, commercial, or agricultural purposes, or those made with government agencies or instrumentalities or with organizations.

"(2) A lease of a safe deposit box.

"(3) A lease or bailment of personal property which is incidental to the lease of real property, and which provides that the consumer has no liability for the value of the property at scheduled expiration except for abnormal wear and tear and that the consumer has no option to purchase the leased property.

"§ 105. Regulations

"(a) The Board shall write regulations to carry out the purposes of this title, to prevent its circumvention, and to facilitate compliance with its requirements. The regulations may contain classifications and differentiations and may provide for adjustments and exceptions for any class of transaction.

"(b) The Board shall publish model disclosure forms and clauses to facilitate compliance with the disclosure requirements and to aid the consumer in understanding the transaction. In designing forms, the Board shall consider the use by lessors of data processing or similar automated equipment. Use of the models shall be optional. A lessor who properly uses the models shall be deemed to be in compliance with the disclosure requirements.

"(c) Any regulation of the Board, or any amendment or interpretation thereof, that requires a disclosure different from the disclosures previously required shall have an effective date of October 1 that follows the date of promulgation by at least six months. The Board may at its discretion lengthen that period of time to permit lessors to adjust their forms to accommodate new requirements. The Board may also shorten that period of time if it makes a specific finding that such action is necessary to comply with the findings of a court or to prevent unfair or deceptive practices. In any case, lessors may comply with any newly promulgated disclosure requirement prior to its effective date.

"CHAPTER 2—CONSUMER LEASES AND RENTAL-PURCHASE AGREEMENTS

"§ 111. General requirements of disclosure

"(a) The lessor shall disclose to the consumer the information required by this title. In a transaction involving more than one consumer, a lessor need disclose to only one of the consumers who are primarily obligated. In a transaction involving more than one lessor, only one lessor need make the disclosures.

"(b) The disclosures shall be made at or before consummation of the consumer lease or rental-purchase agreement.

"(c) The disclosures shall be made clearly and conspicuously in writing, in a form that the consumer may keep. The disclosures required under sections 112 and 114 shall be segregated from all other terms, data, or information provided.

"(d) Information required to be disclosed may be given in the form of estimates and identified as such when the lessor does not know the exact information.

"(e) If a disclosure becomes inaccurate as the result of any act, occurrence, or agreement after delivery of the required disclosures, the resulting inaccuracy is not a violation of this title.

"§ 112. Consumer lease disclosures

"For each consumer lease, the lessor shall disclose the following items, as applicable:

"(1) The total of initial payments required at or before consummation of the lease or delivery of the property, whichever is later.

"(2) The number, amounts, and timing of scheduled payments.

"(3) The total of scheduled payments.

"(4) The total of amounts payable at the expiration of the lease (not including any difference between the anticipated residual value and the actual residual value).

"(5) The total lease cost, which is the sum of items (1), (3), and (4).

"(6) The amount of any required security deposit.

"(7) When the consumer buys required insurance from or through the lessor, the total cost. When the consumer does not buy required insurance from or through the lessor, a statement that the consumer must buy insurance and that the cost is not included in the numerical disclosures.

"(8) When any official fees and taxes are paid to or through the lessor, the total cost. When any official fees or taxes are not paid to or through the lessor, a statement that the consumer must pay official fees or taxes and that the amounts are not included in the numerical disclosures.

"(9) Any dollar charge or percentage amount that may be imposed for a late payment, other than a deferral or extension charge.

"(10) A statement that the consumer may be liable for additional amounts if the lease is terminated early.

"(11) When the consumer's liability is based on the residual value of the property, a statement that the consumer may have the property appraised at the consumer's expense by an independent third party agreed to by the consumer and lessor, and that the parties will be bound by the appraisal.

"(12) When the consumer's liability at the end of the lease term is based on the anticipated residual value of the property:

"(A) The anticipated residual value of the property, marked as wholesale or retail;

"(B) A brief statement of the consumer's potential liability at the end of the lease term;

"(C) The product of three times the average payment allocable to a month; and

"(D) A statement that the consumer's liability will generally be limited to item (12)(C) unless the excess is a result of excessive use or unreasonable wear and use, or the lessor brings a successful court action proving that the estimate of the anticipated residual value was reasonable.

"(13) A statement that the consumer may have other costs and that the consumer should refer to the appropriate lease document for information about nonpayment and default, wear and use standards, and maintenance responsibility.

"§ 113. Consumer's liability at early termination or at the end of the lease term

"(a) When the consumer's liability at the end of the lease term is based on the anticipated residual value of the leased property, the anticipated residual value shall be a reasonable estimate of the actual residual value of the property at the end of the lease term. There shall be a rebuttable presumption that the anticipated residual value is unreasonable to the extent that it exceeds the actual residual value at the end of the lease term by more than three times the average payment allocable to a month. The lessor shall not collect any amount in excess of three times the average payment allocable to a month unless the lessor brings a successful action in court providing that the estimate was reasonable. If the lessor fails to rebut the presumption, the lessor must pay the costs of the action and the consumer's reasonable attorney's fees.

"(b) The presumption in subsection (a) shall not apply to the extent that the excess of the anticipated residual value over the actual residual value is due to damage to the property beyond reasonable wear and use or to excessive use. The lessor may set reasonable standards for wear and use in the lease.

"(c) Subsection (a) does not preclude the right of a willing consumer and lessor to make a mutually agreeable final adjustment with respect to the excess of three times the average payment allocable to a month, provided the agreement is made after the end of the lease term.

"(d) In the lease the lessor may specify penalties or other charges for delinquency, default, or early termination, if the amounts are reasonable in light of the anticipated or actual harm caused by the delinquency, default, or early termination, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy.

"(e) When the consumer's liability is based on the residual value of the leased property, the consumer may obtain at the consumer's expense a professional appraisal of the property by an independent third party agreed to by both parties. This appraisal shall be binding on the parties.

"§ 114. Rental-purchase disclosures

"For each rental-purchase agreement, the lessor shall disclose the following items, as applicable:

"(1) The number, amounts and timing of all payments necessary to acquire ownership of the property.

"(2) The number of payments and the total of payments necessary to acquire ownership of the property.

"(3) A statement that the consumer will not own the property until the consumer has made the number of payments and the total of payments necessary to acquire ownership.

"(4) A statement that the total of payments does not include other charges, such as late payment, default, pickup, and reinstatement fees, and that the consumer should see the contract for an explanation of these charges.

"(5) A statement that the consumer is responsible for the fair market value of the property if it is lost, stolen, damaged, or destroyed.

"(6) A statement indicating whether the property is new or used.

"§ 115. Renegotiations and extensions

"(a) A renegotiation occurs when an existing consumer lease or rental-purchase agreement is satisfied and replaced by a new lease or agreement undertaken by the same lessor and consumer. A renegotiation is a new lease or agreement requiring new disclosures. However, events such as the following shall not be treated as renegotiations:

"(1) The addition or return of property in a multiple-item lease or agreement or the substitution of the leased property, if in either case the average payment allocable to a payment period is not changed by more than 25 per centum.

"(2) A deferral or extension of one or more periodic payments, or portions of a periodic payment.

"(3) A reduction in charges in the lease or agreement.

"(4) A lease or agreement involving a court proceeding.

"(5) Any other event described in regulations prescribed by the Board.

"(b) No disclosures are required for any extension of a consumer lease or a rental-purchase agreement. However, a lessor that extends or permits a consumer to extend a consumer lease for more than one month beyond the end of the lease term shall (for purposes of section 113) recalculate the anticipated residual value of the leased property to reflect the depreciation resulting from the extended term.

"§ 116. Consumer lease advertising

"(a) If an advertisement for a consumer lease states the amount of any payment or states that any or no initial payment is required, the advertisement must also clearly and conspicuously state the following items, as applicable:

"(1) That the transaction advertised is a lease.

"(2) The total of initial payments required at or before consummation of the lease or delivery of the property, whichever is later.

"(3) That a security deposit is required.

"(4) The number, amounts, and timing of scheduled payments.

"(5) For a lease in which the consumer's liability at the end of the lease term is based on the anticipated residual value of the property, that an extra charge may be imposed at the end of the lease term.

"(b) Any owner or personnel of any medium in which an advertisement appears or through which it is disseminated shall not be liable under this section.

"§ 117. Rental-purchase advertising

"(a) If an advertisement for a rental-purchase agreement refers to or states the amount of any payment or the right to acquire ownership, the advertisement must also clearly and conspicuously state the following items, as applicable:

"(1) That the transaction advertised is a rental-purchase agreement.

"(2) The total of payments necessary to acquire ownership.

"(3) That the consumer acquires no ownership rights if the total amount necessary to acquire ownership is not paid.

"(b) Any owner or personnel of any medium in which an advertisement appears or through which it is disseminated shall not be liable under this section.

"CHAPTER 3—ENFORCEMENT AND LIABILITY

"§ 121. Administrative enforcement

"(a) Compliance with the requirements imposed by this title shall be enforced under—

"(1) section 8 of the Federal Deposit Insurance Act, in the case of—

"(A) national banks, by the Comptroller of the Currency;

"(B) member banks of the Federal Reserve System (other than national banks), by the Board; and

"(C) banks insured by the Federal Deposit Insurance Corporation (other than members of the Federal Reserve System), by the Board of Directors of the Federal Deposit Insurance Corporation; and

"(2) section 5(d) of the Home Owners' Loan Act of 1933, section 407 of the National Housing Act, and sections 6(i) and 17 of the Federal Home Loan Bank

Act, by the Federal Home Loan Bank Board (acting directly or through the Federal Savings and Loan Insurance Corporation), in the case of any institution subject to any of those provisions;

"(3) the Federal Credit Union Act, by the National Credit Union Administration with respect to any Federal credit union;

"(4) the Packers and Stockyards Act, 1921 (except as provided in sections 406 of that Act), by the Secretary of Agriculture with respect to any activities subject to that Act; and

"(5) the Farm Credit Act of 1971, by the Farm Credit Administration with respect to any Federal land bank, Federal land bank association, Federal intermediate credit bank, or production credit association.

"(b) For the purpose of the exercise by any agency referred to in subsection (a) of its powers under any Act referred to, a violation of a requirement imposed by this title shall be deemed to be a violation of a requirement imposed under that Act. In addition to its powers under any provision of law specifically referred to in subsection (a), each agency may exercise any other authority conferred on it by law in enforcing any requirement imposed under this title.

"(c) Except to the extent that enforcement of the requirements imposed by this title is specifically committed to some other agency under subsection (a), the Federal Trade Commission shall enforce the requirements. For the purpose of exercising its functions and powers under the Federal Trade Commission Act, a violation of any requirement imposed by this title shall be deemed a violation of a requirement imposed under that Act. All of the functions and powers of the Federal Trade Commission under the Federal Trade Commission Act are available to the Commission to enforce compliance by any person with the requirements imposed by this title, whether or not that person is engaged in commerce or meets any other jurisdictional tests in the Federal Trade Commission Act.

"(d) The authority of the Board to issue regulations under this title does not impair the authority of any other agency designated in this section to make rules respecting its own procedures in enforcing compliance with requirements imposed by this title.

"§ 122. Civil liability

"(a) Except as otherwise provided in this title, a lessor who fails to comply with a requirement of sections 111, 112, 113, 114, or 115 with respect to a consumer is liable to the consumer in an amount equal to the sum of—

"(1) actual damages sustained by the consumer as a result of the violation;

"(2) in the case of an individual action relating to a consumer lease, 25 per centum of the total of scheduled payments under the lease, but not less than $100 nor greater than $1,000;

"(3) in the case of an individual action relating to a rental-purchase agreement, 25 per centum of the total of payments necessary to acquire ownership, but not less than $100 nor greater than $1,000;

"(4) In the case of a class action, the amount the court determines to be appropriate with no minimum recovery as to each member. The total recovery in any class action or series of class actions arising out of the same violation may not be more than the lesser of $500,000 or 1 per centum of the net worth of the lessor. In determining the amount of the award in any class action, the court shall consider, among other relevant factors, the amount of actual damages awarded, the frequency and persistence of the violation, the lessor's resources, and the extent to which the lessor's violation was intentional; and

"(5) the costs of the action and reasonable attorney's fees as determined by the court.

"(b) In the case of an advertisement, any lessor who fails to comply with the requirements of sections 116 and 117 with regard to any person is liable to that person for actual damages suffered from the violation, the costs of the action, and reasonable attorney's fees.

"(c) When there are multiple lessors, liability shall be imposed only on the lessor who made the disclosures. When no disclosures have been given, liability shall be imposed on all lessors.

"(d) When there are multiple consumers in a consumer lease or a rental-purchase agreement, there shall be only one recovery of damages under subsection (a) for a violation of this title.

"(e) Multiple violations in connection with a single consumer lease or rental-purchase agreement entitle the consumer to a single recovery under this section.

"(f) An action under this section may be brought in any United States district court or in any other court of competent jurisdiction within one year of the date of the occurrence of the violation, except that in the case of a violation under section 113 an action may be brought within one year of the end of the lease term. This subsection does not bar a consumer from asserting a violation of this title in an action to collect the debt brought more than one year from the date of the occurrence of the violation as a matter of defense by recoupment or setoff, except as otherwise provided by State law.

"(g) A consumer may not take any action to offset any amount for which a lessor is potentially liable under subsection (a) against any amount owed by the consumer, unless the amount of the lessor's liability has been determined by judgment of a court of competent jurisdication in an action in which the lessor was a party. This subsection does not bar a consumer then in default on the obligation from asserting a violation of this title as an original action, or as a defense or counterclaim to an action brought by the lessor to collect amounts owed by the consumer.

"§ 123. Defenses

"(a) A lessor is not liable under sections 121, 122, or 125 for a violation of the requirements of sections 111, 112, and 114 if within sixty days after discovering the error, and before an action under section 122 is filed or written notice of the error is received from the consumer, the lessor notifies the consumer of the error and makes whatever adjustments in the account are necessary to assure that the consumer will not be required to pay an amount in excess of the amounts actually disclosed. This provision applies whether the discovery of the error was made through a final written examination report or the lessor's own procedures.

"(b) A lessor is not liable under section 122 for a violation of this title if the lessor shows by a preponderance of evidence that the violation was not intentional and resulted from a bona fide error even though the lessor maintained procedures reasonably adapted to avoid such error. Examples of a bona fide error include, but are not limited to, clerical, calulation, computer malfunction and programing, and printing errors. An error of legal judgment with respect to the requirements of this title is not a bona fide error.

"(c) A lessor is not liable under this title for any act done or omitted in good faith in conformity with any rule, regulation, interpretation, or approval promulgated by the Board or by an official duly authorized by the Board. This rule applies even if, after the act or omission has occurred, the rule, regulation, interpretation, or approval is amended, rescinded, or determined by judicial or other authority to be invalid for any reason.

"§ 124. Liability of assignees

"(a) For purposes of sections 122 and 123, the term 'lessor' as used in those sections shall include an assignee of the lessor. However, a civil action for a violation of this title may be brought against an assignee only if the violation is apparent on the face of the disclosure statement. A violation apparent on the face of the disclosure statement includes, but is not limited to, a disclosure that can be determined to be incomplete or inaccurate from the face of the disclosure statement or other documents assigned. An assignee has no liability where the assignment is involuntary.

"(b) In an action by or against an assignee, the consumer's written acknowledgement of receipt shall be conclusive proof that the disclosures were made, provided the assignee had no knowledge that disclosures had not been made when the assignee acquired the obligation.

"§ 125. Criminal liability

"A fine of $5,000 or a prison term of not more than one year, or both, may be imposed on anyone who willfully and knowingly fails to comply with any requirement imposed under this title.

"CHAPTER 4—MISCELLANEOUS

"§ 131. Relation to State laws

"(a) This title does not annul, alter, or affect the laws of any State regarding the disclosure of consumer leases or rental-purchase agreements, nor does this title exempt any person subject to the provisions of this title from complying with the laws of any State with respect to consumer leases or rental-purchase agreements, except to the extent those laws are inconsistent with any provision of this title, and then only to the extent of the inconsistency. The laws of a State are inconsistent if a person is unable to comply with them without violating a provision of this title. The Board is authorized to determine whether such inconsistencies exist.

"(b) The Board shall by regulation exempt from the requirements of this title any class of lease transactions and rental-purchase agreements within any State if it determines that the State law contains requirements substantially similar to those imposed by this title or gives greater protection and benefit to the consumer, and that there is adequate provision for enforcement.

"(c) Except as specified in sections 122 and 123, this title does not affect the validity or enforceability of any contract or obligation under State or Federal law.

"(d) Determinations under this section may be requested by any State.

"§ 132. Effect on governmental agencies

"No civil or criminal penalty provided by this title for violations may be imposed on the United States or any of its departments or agencies, any State or political subdivision, or any agency of any State or political subdivision.

"§ 133. Reports by Board and Attorney General

"Each year the Board and the Attorney General shall report to the Congress concerning the administration of their functions under this title, including any recommendations necessary or appropriate. In addition, the Board's report shall include its assessment of the extent to which compliance with the requirements imposed by this title is being achieved.

"§ 134. Effective date

"(a) This title shall take effect on the October 1 that is at least two years after the date of its enactment.

"(b) All regulations, forms, and clauses required to be prescribed shall be promulgated one year prior to such effective date.

"(c) Notwithstanding subsections (a) and (b), any lessor may comply with the requirements of this title, in accordance with the regulations, forms, and clauses prescribed by the Board, prior to such effective date.".

CONFORMING AMENDMENTS

SEC. 503. (a) Section 102 of the Truth in Lending Act is amended by striking out "(a)" before "The Congress" and by striking out subsection (b).

(b) Section 105(b) of such Act is amended by striking out "or lessee", by striking out "or lessors", and by striking out "or lessor" each place it appears.

(c) Section 105(d) of such Act is amended by striking out ", or chapter 5", by striking out "or lessors" each place it appears, and by striking out "or lessor".

(d) Section 121(a) of such Act is amended by striking out "a consumer lease or", and by striking out "or lessor".

(e) Section 121(b) of such Act is amended by striking out "or one lessor as defined in section 181(3)," and by striking out "or lessor" each place it appears.

(f) Section 122(b) of such Act is amended by striking out "or lessor" and by striking out "chapters 4 and 5" and inserting in lieu thereof "chapter 4".

(g) Section 130(a) of such Act is amended by striking out "or 5", by striking out "(i)", by striking out "or (ii) in the case of an individual action relating to a consumer lease under chapter 5 of this title, 25 per centum of the total amount of monthly payments under the lease,", and by striking out "or 5".

(h) Section 130(b) of such Act is amended by striking out "or chapter 5".

(i) Section 130(d) of such Act is amended by striking out "or consumer lease".

(j) Section 130(g) of such Act is amended by striking out "or 5" and by striking out "consumer lease,".

(k) Chapter 5 of title I of the Consumer Credit Protection Act is repealed.

TITLE VI—FAIR DEPOSIT AVAILABILITY

SHORT TITLE

SEC. 601. This title may be cited as the "Fair Deposit Availability Act of 1983".

DEFINITIONS

SEC. 602. As used in this title—

(1) the term "depository institution" means—

(A) Any insured bank as defined in section 3 of the Federal Deposit Insurance Act or any bank which is eligible to make application to become an insured bank under section 5 of such Act;

(B) any mutual savings bank as defined in section 3 of the Federal Deposit Insurance Act or any bank which is eligible to make application to become an insured bank under section 5 of such Act;

(C) any savings bank as defined in section 3 of the Federal Deposit Insurance Act or any bank which is eligible to make application to become an insured bank under section 5 of such Act;

(D) any insured credit union as defined in section 101 of the Federal Credit Union Act or any credit union which is eligible to make application to become an insured credit union pursuant to section 201 of such Act;

(E) any member as defined in section 2 of the Federal Home Loan Bank Act; and

(F) any insured institution as defined in section 401 of the National Housing Act or any institution which is eligible to make application to become an insured institution under section 403 of such Act;

(2) the term "deposit account" means an account in a depository institution on which the account holder is permitted to make withdrawals by negotiable or transferable instrument, payment orders of withdrawal,

telephone transfers, or other similar items for the purpose of making payments or transfers to third persons or others. Such term includes demand deposits, negotiable order of withdrawal draft accounts, savings deposits subject to automatic transfers, share draft accounts, and all savings deposits and share accounts (other than time deposits); and

(3) the term "Board" means the Board of Governors of the Federal Reserve System.

DISCLOSURE OF FUND AVAILABILITY POLICIES

SEC. 603. (a) Before opening a transaction account, a depository institution shall, in accordance with regulations of the Board, provide a written disclosure to the potential customer of its general policy with respect to when a customer may withdraw funds deposited by check or similar instrument into the customer's deposit account.

(b) A depository institution shall, in accordance with regulations of the Board, either—

(1) furnish its customers preprinted deposit slips, or envelopes for automatic teller machine deposits, bearing a summary statement of its general policy with respect to when a customer may withdraw funds deposited by check or similar instrument into the customer's deposit account; or

(2) in the case of a particular deposit by check or similar instrument into a deposit account for which funds may not be immediately available for withdrawal, provide specific notice of the time the customer may withdraw such funds.

INTEREST ON DEPOSITS

SEC. 604. For the purpose of computing the amount of interest or dividends payable with respect to an interest bearing deposit account, a depository institution may not delay beginning to compute interest on funds deposited by check or similar instrument to such an account beyond the date on which that depository institution receives provisional credit for the check or similar instrument. Nothing in the preceding sentence requires the payment of interest with respect to funds deposited by check or similar instrument which is returned unpaid.

COMPLIANCE WITH ENDORSEMENT STANDARD

SEC. 605. Each depository institution shall place its endorsement on checks and other items described in regulations of the Board in the positions provided for in the endorsement standard (ANSI X 9.3–1981) or in regulations of the Board.

EXPEDITED NOTICE OF NONPAYMENT

SEC. 606. Not later than twenty-four hours after a payor depository institution determines not to pay a check or similar instrument of $250 or more, it shall directly notify the depository institution at which the check was originally deposited of such nonpayment.

DISCLOSURE GUIDELINES

SEC. 607. (a) The Board shall prescribe regulations to carry out this title. These regulations may contain such definitions, classifications, differentiations, or other provisions, and may provide for such adjustments and exemptions for any class of transactions, as the Board determines are necessary.

(b) The Board shall publish model disclosure forms and clauses for common transactions to facilitate compliance with the disclosure requirements of section 603 and to aid customers by utilizing readily understandable language. Nothing in this title may be construed to require the use of any such model form or clause prescribed by the Board under this section. A depository institution shall be deemed to be in compliance with the provisions of section 603 if it (1) uses any appropriate model form or clause as published by the Board, or (2) uses any such model form or clause and changes if by (A) deleting any information which is not required by this title, or (B) rearranging the format.

(c) Model disclosure forms and clauses shall be adopted by the Board after notice duly given in the Federal Register and an opportunity for public comment in accordance with section 553 of title 5, United States Code.

ADMINISTRATIVE ENFORCEMENT

SEC. 608. (a) Compliance with the requirements imposed under this title shall be enforced under—

(1) section 8 of the Federal Deposit Insurance Act in the case of—

(A) national banks, by the Comptroller of the Currency;

(B) member banks of the Federal Reserve System (other than national banks), by the Board; and

(C) banks insured by the Federal Deposit Insurance Corporation (other than members of the Federal Reserve System), by the Board of Directors of the Federal Deposit Insurance Corporation;

(2) section 5(d) of the Home Owner's Loan Act of 1933, section 407 of the National Housing Act, and section 17 of the Federal Home Loan Bank Act, by the Federal Home Loan Bank Board (acting directly or through the Federal Savings and Loan Insurance Corporation), in the case of any institution subject to any of those provisions; and

(3) the Federal Credit Union Act, by the Administrator of the National Credit Union Administration

with respect to any Federal credit union or insured credit union.

(b) For the purpose of the exercise by any agency referred to in subsection (a) of this section of its powers under any Act referred to in that subsection, a violation of any requirement imposed under this title shall be deemed to be a violation of a requirement imposed under that Act. In addition to its powers under any provision of law specifically referred to in subsection (a) of this section, each of the agencies referred to in that subsection may excerise, for the purpose of enforcing compliance with any requirement imposed under this title, any other authority conferred on it by law.

(c) Except to the extent that enforcement of the requirements imposed under this title is specifically committed to some other Government agency under subsection (a) of this section, the appropriate State regulatory authority shall enforce such requirements.

(d) The authority of the Board to issue regulations under this title does not impair the authority of any other authority designated in this section to make rules respecting its own procedures in enforcing compliance with requirements imposed under this title.

CIVIL LIABILITY

SEC. 609. (a) Except as otherwise provided in this section, any depository institution which fails to comply with any requirement imposed under section 603 or 604 with respect to any person is liable to such person in an amount equal to the sum of—

(1) any actual damage sustained by such person as a result of the failure;

(2)(A) in the case of an individual action such additional amount as the court may allow, except that the liability under this subparagraph shall not be less than $50 nor greater than $500; or

(B) in the case of a class action, such amount as the court may allow, except that, as to each member of the class, no minimum recovery shall be applicable, and the total recovery under this subparagraph in any class action or series of class actions arising out of the same failure to comply by the same depository institution shall not be more than the lesser of $500,000 or 1 per centum of the net worth of the depository institution; and

(3) in the case of any successful action to enforce the foregoing liability, the costs of the action, together with a reasonable attorney's fee as determined by the court.

In determining the amount of award in any class action, the court shall consider, among other relevant factors, the amount of any actual damages awarded, the frequency and persistence of failures of compliance, the resources of the depository institution, the number of persons adversely affected, and the extent to which the failure of compliance was intentional.

(b) A depository institution may not be held liable in any action brought under this section for a violation of section 603 or 604 if the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error. Examples of a bona fide error include, but are not limited to, clerical, calculation, computer malfunction and programing, and printing errors, except that an error of legal judgment with respect to a person's obligations under this title is not a bona fide error.

(c) Any action under this section may be brought in any United States district court, or in any other court of competent jurisdiction, within one year from the date of the occurrence of the violation.

(d) No provision of this section imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or interpretation thereof by the Board or in conformity with any interpretation or approval by an official or employee of the Federal Reserve System duly authorized by the Board to issue such interpretations or approvals under such procedures as the Board may prescribe therefor, notwithstanding that after such act or omission has occurred, such rule, regulation, interpretation, or approval is amended, rescinded, or determined by judicial or other authority to be invalid for any reason.

EFFECTIVE DATE

SEC. 610. This title takes effect upon the expiration of twelve months following its enactment.

TITLE VII—CREDIT DEREGULATION AND AVAILABILITY

SHORT TITLE

SEC. 701. This title may be cited as the "Credit Deregulation and Availability Act of 1983".

BUSINESS AND AGRICULTURAL CREDIT

SEC. 702. (a) Section 511 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (94 Stat. 161; Public Law 96-221) is amended to read as follows:

"BUSINESS AND AGRICULTURAL LOANS

"SEC. 511. (a) The provisions of the constitution or the laws of any State prohibiting, restricting, or in any way limiting the rate, nature, type, amount of, or the manner of calculating or providing or contracting for interest, discount, points, a time price differential, finance charges or other fees or charges that may be charged, taken, received, or reserved shall not apply in the case of business or agricultural credit.

"(b) As used in this part, the term—

"(1) 'agricultural credit' means credit extended primarily for agricultural purposes to a person that cultivates, plants, propagates, or nurtures an agricultural product;

"(2) 'agricultural purposes' include the production, harvest, exhibition, marketing, transportation, processing, or manufacturing of an agricultural product and the acquisition of farmland, real property with a farm residence and personal property and services used primarily in farming;

"(3) 'agricultural product' includes agricultural, horticultural, viticultural, and dairy products, livestock, wildlife, poultry, bees, forest products, fish and shellfish and any products thereof, including processed and manufactured products and any and all products raised or produced on farms and any processed or manufactured products thereof;

"(4) 'business credit' means credit extended primarily for business or commercial purposes, including investment, and any credit extended to a person other than a natural person; and

"(5) 'credit' includes all secured and unsecured loans, credit sales, forbearances, advances, renewals and other extensions of credit.".

(b) Section 512 of the Depository Institutions Deregulation and Monetary Control Act of 1980 is amended to read as follows:

"APPLICABILITY

"SEC. 512. (a) Except as provided in subsection (b) of this section, the provisions of this part shall apply with respect to business and agricultural credit extended on or after April 1, 1980.

"(b) The provisions of this part shall not apply to any business or agricultural credit extended in any State after the effective date (if such effective date occurs on or after April 1, 1980, and prior to three years after the effective date of the Credit Deregulation and Availability Act of 1983) of a State law or a certification that the voters of such States have voted in favor of any provision, constitutional or otherwise, which states explicitly and by its terms that such State does not want the provisions of this part to apply with respect to credit extensions subject to the laws of such State, except that such provisions shall apply to any credit extended on or after such date pursuant to a commitment to extend such credit which was entered into on or after April 1, 1980, and prior to such later date.

"(c) Credit shall be deemed to be extended during the period to which the provisions of this part apply if such credit extension—

"(1)(A)(i) is funded or made in whole or in part during such period, regardless of whether pursuant to a commitment or other agreement therefor made prior to April 1, 1980;

"(ii) was made prior to or on April 1, 1980, and bears or provides for interest during such period on the outstanding amount thereof at a variable or fluctuating rate; or

"(iii) is a renewal, extension, or other modification of an extension of credit made prior to April 1, 1980, and such renewal or extension or other modification is made during such period with the written consent of any person obligated to repay such credit; and

"(B)(i) has an original principal amount of $25,000 or more ($1,000 or more on or after the date of enactment of the Housing and Community Development Act of 1980 or any amount on or after the effective date of the Credit Deregulation and Availability Act of 1983); or

"(ii) is part of a series of advances if the aggregate of all sums advanced or agreed or contemplated to be advanced pursuant to a commitment or other agreement therefor is $25,000 or more ($1,000 or more on or after the date of enactment of the Housing and Community Development Act of 1980 or any amount on or after the effective date of the Credit Deregulation and Availability Act of 1983); or

"(2) is a renewal, extension, other modification or use of a credit agreement or extension made during such period, including an agreement entered during that period that contemplates future extensions of credit from time to time in which the charges that are assessed for or in connection with credit are calculated from time to time, in whole or in part, on the basis of the outstanding balance and the credit is extended not later than eighteen months after the effective date of the State law or certification.".

CONSUMER CREDIT

SEC. 703. Title V of the Depository Institutions Deregulation and Monetary Control Act of 1980 (94 Stat. 161; Public Law 96-221) is amended by adding at the end thereof the following new part:

"PART D—CONSUMER CREDIT

"CONSUMER CREDIT

"SEC. 531. The provisions of the constitution or laws of any State prohibiting, restricting, or in any way limiting the rate, nature, type, amount of, or the manner of calculating or providing or contracting for covered charges that may be charged, taken, received or reserved shall not apply to an extension of consumer credit made by a creditor.

"DEFINITIONS

"SEC. 532. (a) As used in this part—

"(1) the term 'covered charges' means—

"(A) interest, discount, points, a time price differential, or any similar fees, charges, or other compensation paid to the creditor and arising out of the credit agreement or transaction for the use of credit or credit services. The term shall not include, however, fees, charges or other amounts paid to the creditor or arising out of the credit agreement or transaction that are paid or arise solely as the result of the failure or refusal of the debtor to comply with the terms and conditions of the debtor's agreement with the creditor, including without limitation the fact that the obligation is not repaid in accordance with the payment schedule; and

"(B) fees or charges paid for the availability of credit, payment mechanism services, or for similar purposes, including periodic, transaction and access fees;

"(2) the term 'credit' includes all secured and unsecured loans, credit sales, forbearances, advances, renewals and other extensions of credit, all without regard to the nature of any property that might secure its repayment;

"(3) the term 'creditor' means any person that regularly makes extensions of consumer credit, which, for purposes of this definition, shall include extensions of credit that are subject to the provisions of section 501(a) of this title. A person is not a 'creditor' with respect to a specific extension of consumer credit if, except for this part, in order to assess or collect covered charges in connection with that transaction, the person would be required to comply with licensing requirements imposed under State law, unless such person is licensed under applicable State law and such person remains, or becomes, subject to the applicable regulatory requirements and enforcement mechanisms provided by State law; and

"(4) the term 'extension of consumer credit' means any credit extended to a natural person primarily for personal, family, or household purposes, except that it does not include credit subject to the provisions of section 501(a) or 511(a) of this title.

"APPLICABILITY

"SEC. 533. (a) Except as provided in subsection (b) of this section, the provisions of section 531 shall apply with respect to any extension of consumer credit made by a creditor on or after the effective date of the Credit Deregulation and Availability Act of 1983.

"(b)(1) The provisions of section 531 shall not apply to any extension of consumer credit in any State made on or after the effective date (if such effective date occurs on or after the effective date of the Credit Deregulation and Availability Act of 1983 and prior to a date three years after such effective date) of a State law or a certification that the voters of such State have voted in favor of any provision, constitutional or otherwise, which states explicitly and by its terms that such State does not want the provisions of this part to apply with respect to extensions of consumer credit subject to the laws of such State, except that such provisions shall apply to any consumer credit extended on or after such date pursuant to an agreement to extend such credit which was entered into on or after the effective date of the Credit Deregulation and Availability Act of 1983 and prior to such later date.

"(2) Credit shall be deemed to have been extended during the period to which the provisions of this part apply, if it—

"(A) is funded or extended in whole or in part during such period, regardless of whether pursuant to a commitment or other agreement therefor made prior to that period;

"(B) was made prior to such period and bears or provides for covered charges that may vary or fluctuate during that period;

"(C) is a renewal, extension, or other modification of a credit extension made before such period and such renewal, extension or other modification is made during such period with the written consent of any person obligated to repay such credit; or

"(D) is extended in accordance with an agreement entered into prior to the effective date of the State law or certification that contemplates future extensions of consumer credit from time to time in which the covered charges are calculated from time to time, in whole or in part, on the basis of the outstanding balance and the credit is extended not later than eighteen months after the effective date of the State law or certification.

"(c) Any law or certification adopted by a State or its voters pursuant to subsection (b) of this section may specify that portion of the extension of consumer credit made in such State, or those types or kinds of covered charges, to which the provisions of section 531 will not apply.

"INTERPRETIVE AUTHORITY

"SEC. 534. (a) The Board of Governors of the Federal Reserve System is authorized to publish Board interpretations regarding the scope and application of section 531 of this part. Upon its own motion or upon the request of any creditor, State, or other interested party which is submitted to the Board in accordance with procedures it establishes, within one hundred and twenty days the Board shall issue an official interpretation regarding the scope of section 531 and its relationship to specific provisions of State law, or shall make public a Board determination (accompanied by an appropriate explanation) that the question presented does not involve a significant issue or does not affect a substantial number of creditors or extensions of consumer credit.

"(b) No provision of the constitution or laws of any State imposing any liability, penalty, or forfeiture shall apply to any act done or omitted in good faith in conformity with any interpretation under this section by the Board, notwithstanding that, after such act of omission has occurred, such interpretation is amended, rescinded, or determined by judicial or other authority to be invalid for any reason.".

FEDERAL CREDIT UNIONS

SEC. 704. Section 107(5)(A)(vi) of the Federal Credit Union Act (12 U.S.C. 1757(5)(A)(vi)) is amended to read as follows:

> "(vi) rates of interest shall be established by the board of directors of the Federal credit union;".

EFFECTIVE DATE

SEC. 705. This title shall take effect upon its enactment.

TITLE VIII—INTEREST ON DEMAND DEPOSITS

SHORT TITLE

SEC. 801. This title may be cited as the "Demand Deposit Deregulation Act".

AMENDMENTS TO THE FEDERAL RESERVE ACT

SEC. 802. (a) The first and second sentences of section 19(i) of the Federal Reserve Act (12 U.S.C. 371a) are hereby repealed.

"(b) The third sentence of section 19(i) of the Federal Reserve Act is amended by striking out "Notwithstanding any other provision of this section, a" and inserting in lieu thereof "A".

AMENDMENT TO THE FEDERAL DEPOSIT INSURANCE ACT

SEC. 803. The first sentence of section 18(g)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)(1)) is hereby repealed.

AMENDMENT TO THE HOME OWNERS' LOAN ACT OF 1933

SEC. 804. The second sentence of section 5(b)(1)(B) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(b)(1)(B)) is hereby repealed.

AMENDMENT TO SECTION 19(b) OF THE FEDERAL RESERVE ACT

SEC. 805. Section 19(b) of the Federal Reserve Act (12 U.S.C. 461(b)) is amended by striking the last sentence in subparagraph (8)(A) and inserting in lieu thereof the following: "This subparagraph does not apply to (1) any category of deposits or accounts which are first authorized pursuant to Federal law in any State after April 1, 1980; nor (2) an amount equal to the amount by which current total demand deposits exceeds the amount of demand deposits held by the institution on a daily average basis during the fourteen-day period preceding the date of enactment of this Act, held by each depository institution located outside of Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, and Vermont, except as permitted by order or regulation of the Board.".

AMENDMENT TO THE DEPOSITORY INSTITUTIONS DEREGULATION ACT OF 1980

SEC. 806. Section 204 of the Depository Institutions Deregulation Act of 1980 (12 U.S.C. 3503) is amended by adding at the end thereof a new subsection (d) to read as follows:

"(d) The Deregulation Committee shall not later than six months from the effective date of this Act establish rules permitting the payment of interest on demand deposits at the same rates that are permitted for accounts subject to withdrawal by negotiable or transferable instrument for the purpose of making transfers to third parties authorized under section 2(a) of Public Law 93-100 (12 U.S.C. 1832(a)). Interest may not be paid by a depository institution on any demand deposit until such rules are issued by the Deregulation Committee.".

TECHNICAL AMENDMENTS

SEC. 807. (a) Section 207(b)(2) of the Depository Institutions Deregulation Act of 1980 (12 U.S.C. 3506(b)(2)) is amended to read as follows:

"(2) the first sentence of section 18(g) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)) is amended by striking out 'payment and' and by striking out ', including limitations on the rates of interest and dividends that may be paid;' ".

(b) Section 207(b)(3) of such Act (12 U.S.C. 3506(b)(3)) is amended to read as follows:

"(3) the second, fourth, and seventh sentences of section 18(g) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)) are hereby repealed;".

(c) The second sentence of section 203(b) of such Act (12 U.S.C. 3502(b)) is hereby repealed.

NOW ACCOUNTS

Sec. 808. Section 2(a)(2) of Public Law 93-100 (12 U.S.C. 1832(a)) is amended by inserting "political" after the comma following "educational".

EFFECTIVE DATE

Sec. 809. This title shall take effect one hundred and eighty days from the date of enactment, except that section 808 shall take effect on the date of enactment of this Act.

TITLE IX—FRAUDULENT USE OF CREDIT CARDS AND DEBIT CARDS

FRAUDULENT USE OF CREDIT CARDS

Sec. 901. Section 134 of the Truth in Lending Act (15 U.S.C. 1644) is amended to read as follows:

"§ 134. Fraudulent use of credit card

"(a) Whoever—

"(1) knowingly, in a transaction affecting interstate or foreign commerce, uses or attempts or conspires to use any counterfeit, fictitious, altered, forged, lost, stolen, or fraudulently obtained credit card to obtain money, goods, services, or anything else of value which within any one-year period has a value aggregating $1,000 or more;

"(2) with unlawful or fraudulent intent, transports or attempts or conspires to transport in interstate or foreign commerce a counterfeit, fictitious, altered, forged, lost, stolen, or fraudulently obtained;

"(3) with unlawful or fraudulent intent, uses any instrumentality of interstate or foreign commerce to sell or transport a counterfeit, fictitious, altered, forged, lost, stolen, or fraudulently obtained credit card knowing the same to be counterfeit, fictitious, altered, forged, lost, stolen, or fraudulently obtained;

"(4) knowingly receives, conceals, uses, or transports money, goods, services, or anything else of value (except tickets for interstate or foreign transportation) which (A) within any one-year period has a value aggregating $1,000 or more, (B) has moved in or is part of, or which constitutes interstate or foriegn commerce, and (C) has been obtained with a counterfeit, fictitious, altered, forged, lost, stolen, or fraudulently obtained credit card;

"(5) knowingly receives, conceals, uses, sells, or transports in interstate or foreign commerce one or more tickets for interstate or foreign transportation, which (A) within any one-year period have a value aggregating $500 or more, and (B) have been purchased or obtained with one or more counterfeit, fictitious, altered, forged, lost, stolen, or fraudulently obtained credit cards;

"(6) in a transaction affecting interstate or foreign commerce, furnishes money, property, services, or anything else of value, which within any one-year period has a value aggregating $1,000 or more, through the use of any counterfeit, fictitious, altered, forged, lost, stolen, or fraudulently obtained credit card knowing the same to be counterfeit, fictitious, altered, forged, lost, stolen, or fraudulently obtained;

"(7) in a transaction affecting interstate or foreign commerce, knowingly furnishes, transfers, or obtains a credit card for use in connection with a scheme to defraud a consumer or any other person;

"(8) in a transaction affecting interstate or foreign commerce, with unlawful or fraudulent intent, furnishes, acquires or uses any actual or fictitious credit card account numbers or identification or other access codes, whether alone or together with names of credit card holders, or other information pertaining to a credit card account in any form, and as they may be reflected or retained in any medium; or

"(9) with unlawful or fraudulent intent, possesses five or more counterfeit, fictitious, altered, forged, lost, stolen, or fraudulently obtained credit cards that have moved in, been a part of, or constituted interstate or foreign commerce, shall be fined not more than $10,000 or imprisoned not more than ten years, or both.

"(b)(1) In determining the aggregate value for the purpose of any provision of subsection (a), there shall be included the dollar value of all transactions by a person using one or more credit cards in a course of conduct in violation of such provision.

"(2) As used in this section, the term 'credit card' includes account numbers or any other means of account access that can be used, alone or in conjunction with another means of access to obtain money, goods, services, or any other thing of value.

"(c) Any person who is convicted of a violation of any provision of subsection (a) or section 916 shall, for any subsequent violation of a provision of subsection (a) or section 916, be fined not more than $100,000 or imprisoned not more than 20 years, or both.".

FRAUDULENT USE OF DEBIT CARDS

SEC. 902. (a) Section 916(b) of the Electronic Fund Transfer Act (15 U.S.C. 1693n(b)) is amended by striking out "obtained—" in paragraph (6) and inserting in lieu thereof the following: "obtained; or

"(7) in a transaction affecting interstate or foreign commerce, knowingly furnishes, transfers, or obtains a debit instrument for use in connection with a scheme to defraud a consumer or any other person; or

"(8) in a transaction affecting interstate or foreign commerce, with unlawful or fraudulent intent, furnishes, acquires, or uses any actual or fictitious account numbers or identification or other access codes, whether alone or together with names of account holders, or other information pertaining to a debit instrument in any form, and as they may be reflected or retained in any medium; or

"(9) with unlawful or fraudulent intent, possesses five or more counterfeit, fictitious, altered, forged, lost, stolen, or fraudulently obtained debit instruments that have moved in, been a part of, or constituted interstate or foreign commerce—".

(b) Section 916(c) of such Act is amended by inserting after "card, code," the following: "account number, other means of account access (that can be used, alone or in conjunction with another access device, to obtain money, goods, services, or any other things of value or for the purpose of initiating a transfer of funds (except a transfer originated solely by a paper instrument)),".

(c) Section 916 of such Act is amended by adding at the end thereof the following:

"(d) In determining the aggregate value for the purpose of any provision of subsection (b), there shall be included the dollar value of all transactions by a person using one or more debit instruments in a course of conduct in violation of such provision.

"(e) Any person who is convicted of a violation of any provision of subsection (b) or of section 134 shall for any subsequent violation of a provision of subsection (b) or section 134, be fined not more than $100,000 or imprisoned not more than 20 years, or both.".

TITLE X—INTERSTATE BANKING

SHORT TITLE

SEC. 1001. This title may be cited as the "Interstate Banking Act of 1983".

AMENDMENT TO SECTION 5155 OF THE REVISED STATUTES

SEC. 1002. The first sentence of subsection (c) of section 5155 of the Revised Statutes (12 U.S.C. 36) is amended—

(1) by striking out "and" before "(2)"; and

(2) by inserting before the period the following: "; and (3) within any other State in which such establishment and operation are at the time authorized to State banks by statute law by language specifically granting such authority affirmatively and not merely by implica-

tion or recognition, subject to any restriction as to location imposed by the laws of the other State on State banks and subject to other limitations in the law of the other State such as the geographic location or proximity of the State in which the association is situated, and subject to such State having in effect a law providing reciprocal treatment of its State banks".

AMENDMENT TO THE BANK HOLDING COMPANY ACT OF 1956

SEC. 1003. Section 3(d) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(d)) is amended by adding at the end thereof the following: "State laws which authorize a bank holding company the banking operations of which are principally conducted in another State to acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of any additional bank located in a State may grant such authority on the basis of limitations such as the geographic location or proximity of such other State or on the basis of such other State having in effect a law providing reciprocal treatment for such transactions.".

AMENDMENTS TO THE HOME OWNERS' LOAN ACT OF 1933

SEC. 1004. (a) Section 5(a) of the Home Owner's Loan Act of 1933 (12 U.S.C 1464(r)) is amended by adding at the end thereof the following:

"(4) An association may establish and operate a branch in any State where the establishment and operation of a branch by an out-of-State association are authorized by statute in language specifically granting such authority affirmatively and not merely by implication or recognition, and subject to any restriction as to location imposed by the laws of the State on State associations. Such statute may grant such authority subject to limitations such as the geographic location or proximity of the other State or subject to such other State having in effect a law providing reciprocal treatment for such establishment and operation.".

(b) Section 5(d)(11) of such Act (12 U.S.C. 1464(d)(11)) is amended—

(1) by inserting "(A)" after "(11)"; and

(2) by adding at the end thereof the following:

"(B) In considering any reorganization or merger involving an association, the Board shall give effect to any State law under which a reorganization or merger involving an association from that State and an association or other financial institution from another State is authorized by statute in language specifically granting such authority affirmatively and not merely by implication or recognition and subject to any restriction as to location imposed by the laws of that State. Such statute may grant such authority subject to limitations such as the geographic location or proximity of the other State or subject to such other State having in effect a law providing reciprocal treatment for such reorganizations or mergers.".

AMENDMENT TO THE NATIONAL HOUSING ACT

SEC. 1005. Section 408(e)(3)(B) of the National Housing Act (12 U.S.C. 1730a(e)(3)(B)) is amended by inserting before the period at the end thereof the following: ", except that the Corporation shall give effect to any State laws which permit a savings and loan holding company whose operations are principally conducted in any other State to acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of any additional association located in that State which laws may permit such acquisition subject to limitations such as the geographic location or proximity of the other State or subject to the other State having in effect a law providing reciprocal treatment for such acquisitions".

AMENDMENTS TO THE FEDERAL DEPOSIT INSURANCE ACT

SEC. 1006. (a) Section 18(d) of the Federal Deposit Insurance Act (12 U.S.C. 1828(d)) is amended by adding at the end thereof the following:

"(3) In considering the application of any State nonmember bank, the Corporation shall give effect to any State laws under which the establishment and operation of a branch by an out-of-State nonmember bank are authorized by statute in language specifically granting such authority affirmatively and not merely by implication or recognition and subject to the restrictions as to location imposed by the laws of the State on State nonmember insured banks. Such State laws may grant such authority subject to limitations such as the geographic location or proximity of the other State or subject to such other State having in effect a law providing reciprocal treatment for such establishment and operation.".

(b) Section 18(c)(5) of such Act (12 U.S.C. 1828(c)(5)) is amended—

(1) by redesignating subparagraphs (A) and (B) as clauses (i) and (ii), respectively;

(2) by inserting "(A)" after "(5)"; and

(3) by adding at the end thereof the following:

"(B) In reviewing any merger transaction, the responsible agency shall give effect to the laws of a State under which a merger transaction involving a bank from that State and a bank from another State is authorized by statute in language specifically granting such authority affirmatively and not merely by implication or recognition and subject to any restriction as to location imposed by the laws of that State. Such State laws grant such authority subject to limitations such as the geographic location or proximity of the other State or subject to such other State having in effect a law providing reciprocal treatment for such mergers.".

SUNSET

SEC. 1007. (a) Effective upon the expiration of five years after the date of enactment of this title—

(1) section 5155(c)(3) of the Revised Statutes, as added by section 1002 of this title, is repealed;

(2) section 7(b) of the Bank Holding Company Act of 1956, as added by section 1003 of this title, is repealed;

(3) section 5(r)(4) of the Home Owners' Loan Act of 1933, as added by section 1004 of this title, is repealed;

(4) that part of section 408(e)(3) of the National Housing Act which was added by section 1005 of this title is repealed;

(5) section 18(d)(3) of the Federal Deposit Insurance Act, as added by section 1006 of this title, is repealed;

(6) section 18(c)(5)(B) of the Federal Deposit Insurance Act, as added by section 1007 of this title, is repealed; and

(7) section 5(d)(11) (B) of the Home Owners' Loan Act of 1933, as added by section 1008 of this title, is repealed.

(b) The repeal or termination by subsection (a) of any amendments made by this title shall have no effect on any action taken or authorized while such amendment was in effect. Any bank or other institution the shares or assets of which are acquired in reliance upon the amendments made by this title shall after repeal of the amendments made by this title have the same powers with respect to the establishment of branch offices and merger or consolidation with other institutions, as it would have had if its shares or assets not been so acquired.

REPORT

SEC. 1008. (a) The President, in consultation with the Attorney General, the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, shall transmit a report to the Congress concerning the effect, if any, that this title has had on the financial, economic, and banking environment and on particular banks, bank holding companies, savings and loan associations, and saving banks. There shall be included in this report legislative recommendations as to whether the sunset provisions of section 1009 should be allowed to take effect.

(b) The report required by subsection (a) shall be transmitted to the Congress not later than four years after the date of enactment of this title.

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II

98th CONGRESS
1st Session

S. 2134

To establish the permissible scope of powers for depository institutions and their holding companies consistent with their safe and sound operations, to simplify the procedures for engaging in such activities, and for other purposes.

IN THE SENATE OF THE UNITED STATES

November 18 (legislative day, November 14), 1983

Mr. Proxmire introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

A BILL

To establish the permissible scope of powers for depository institutions and their holding companies consistent with their safe and sound operations, to simplify the procedures for engaging in such activities, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

Section 1. This Act may be cited as the "Depository Institutions Holding Company Act Amendments of 1983".

AMENDMENTS TO THE BANK HOLDING COMPANY ACT

Sec. 2. Section 2 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841), is hereby amended:

(1) by amending subsection (c) to read as follows:

"(c) 'Bank' means (1) an 'insured bank' as that term is defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)); (2) any institution that is eligible to become an insured bank pursuant to section 5 of the Federal Deposit Insurance Act (12 U.S.C. 1815); or (3) any institution organized under the laws of the United States, any State of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands, that accepts deposits that the depositor may withdraw by check or similar means for payment to third parties and is engaged in the business of making commercial loans. The term 'bank' does not include (A) any foreign bank having an insured branch in the United States; (B) an insured institution; (C) any organization operating under section 25 or section 25(a) of the Federal Reserve Act; (D) any organization that does not do business in the United States except as an incident to its activities outside the United States; or (E) any institution that functions solely as a trust company, such as the type described in section 92a(a) of title 12, United States Code, and all or substantially all of the deposits of which are received solely in a fiduciary capacity."; and

(2) by inserting after subsection (i) the following new subsections:

"(j) The term 'securities affiliate' means any corporation that (1) is engaged in the United States in one or more of the activities authorized pursuant to section 4(c)(15) of this Act, and (2) is a broker or dealer within the meaning of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78c(a)(4) and (5)), or an investment adviser within the meaning of the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-2(11)). For purposes of this chapter, a corporation engaged in any such activities shall be deemed to be a securities affiliate only so long as it is a bank holding company or is owned or controlled by a bank holding company.

"(k) the term 'insured institution' has the meaning ascribed to it in section 408 of the National Housing Act (12 U.S.C. 1730a(a)(1)).".

SEC. 3. Section 3 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1842), is hereby amended by deleting the word "or" before the letter "(B)" in the second sentence of subsection (a) thereof and by adding the following new subparagraph immediately preceding the period at the end of the second sentence of subsection (a): "; or (C) with thirty days prior notification to the Board, the acquisition by a company of control of a bank in a reorganization in which a person or group of persons exchange their shares of the bank for shares of a newly formed bank holding company and receive after such reorganization, substantially the same proportional share interest in the holding company as they held in the bank except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under State or Federal law: *Provided,* That, immediately following such acquisition, the bank holding company meets the capital and other financial standards prescribed by the Board by regulation for such a bank holding company and the holding company does not engage in any activities other than those of banking or managing and controlling banks. In promulgating regulations pursuant to this subsection, the Board shall not require more capital for the subsidiary bank immediately following the reorganization that is required for a similarly sized bank that is not a subsidiary of a bank holding company".

SEC. 4. Subsection 4(a)(2) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(a)(2)), is hereby amended:

(1) by amending subparagraph (B) of such subsection to read as follows: "(B) those permitted under paragraphs (8) and (15) of subsection (c) of this section subject to all the conditions and requirements specified in each respective paragraph or in any order or regulation issued by the Board under such paragraphs"; and

(2) by adding the following additional proviso at the end of such subsection: ":*Provided further,* (I) That the two-year period referred to in this paragraph shall

not apply to a company that becomes a bank holding company as a result of enactment of the Depository Institutions Holding Company Act of 1983, and that acquired a bank between June 23, 1983, and the effective date of such Act; and (II) That a company that becomes a bank holding company as a result of the enactment of the Depository Institutions Holding Company Act of 1983, and that controlled an insured bank on June 23, 1983, may engage in any activity in which it was lawfully engaged, directly or indirectly, on June 23, 1983, and in which it has been engaged continuously since June 23, 1983: *Provided,* That any activities authorized for such a bank holding company may not be expanded and any additional activities may not be commenced except in accordance with the requirements, conditions, and limitations applicable to bank holding companies under this Act. The authority conferred by the preceding clause (II): (a) shall terminate at such time as (1) any bank holding company covered by clause (II) acquires control of an additional bank or an insured institution, (2) any of such bank holding company's existing subsidiary banks commences accepting deposits that the depositor has a legal right to withdraw on demand and engages in the business of making commercial loans, or (3) such bank holding company covered by clause (II) commences, directly or indirectly, after June 23, 1983, any additional activities, other than those activities authorized pursuant to this Act, in which it was not engaged on June 23, 1983; and (b) may be terminated by the Board by order, after opportunity for hearing, if it determines, having due regard to the purposes of this chapter, that such action is necessary to prevent conflicts of interests or unsound banking practices or is in the public interest.".

SEC. 5. Subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C 1843(c)), is hereby amended:

(1) by deleting paragraph (8) and replacing it with the following new paragraph:

"(8)(A) shares of any company the activities of which the Board has determined by regulation, or by order after notice, to be closely related to banking or managing or controlling banks.

"(B)(i) No bank holding company shall engage directly or indirectly in any activity authorized under this paragraph either de novo or by an acquisition in whole or in part of a going concern, unless the Board has been given sixty days prior written notice of such proposal and, within such period, the Board has not issued an order disapproving the proposal or suspending the time period in accordance with clause (iii) of this subparagraph.

"(ii) An acquisition may be made prior to the expiration of the disapproval period specified in clause (i) of this subparagraph, if the Board issues a written notice of its intent not to disapprove the transaction. The Board may provide for no notice under this paragraph or notice for a shorter period of time with respect to particular activities. No notice under this paragraph is required in the event a bank holding company establishes de novo an office to engage in any activity previously authorized for such a bank holding company under this paragraph, or changes the location of an office engaged in such activity, unless the company has been notified that a notice is required based upon any of the criteria specified in clause (iv) of this subparagraph.

"(iii) Any notice required under this paragraph shall contain such information as the Board may prescribe by regulation or by specific request in connection with a particular notice. The Board may require only such information as may be relevant to the nature, scope, or permissibility of the proposed activity and to the Board's evaluation of the criteria in clause (iv) of this subparagraph. In the event the Board requires additional relevant information beyond that provided in the notice submitted pursuant to this paragraph, the Board may by order suspend the time period provided in clause (i) of this subparagraph until it has received such additional relevant information. The activity that is the subject of the notice may be commenced at the expiration of thirty days from the date of receipt by the Board of such additional relevant information, unless the Board issues a disapproval order as provided in clause (i) of this subparagraph or at such earlier date as may be authorized under clause (ii) of this subparagraph. A suspension order issued under this clause is reviewable under section 9 of this Act.

"(iv) In evaluating a notice under this paragraph, the Board may consider the following criteria:

"(I) the managerial resources of the companies involved;

"(II) the adequacy of their financial resources, including their capital, giving consideration to the financial resources and capital of others engaged in similar activities: *Provided*, That the Board shall not require a higher level of capital for any activity subject to Federal or State regulation than would be required by the applicable regulatory authority for a company engaged in such activity, unless the Board shall find that particular circumstances warrant a higher level of capital;

"(III) any practice or arrangement that may adversely affect the independence or impartiality of an affiliated bank in the provision of credit or other services or the terms on which such credit and services are made available, or the availability of such credit; and

"(IV) any material adverse effect on the safety and soundness or financial condition of an affiliated bank or banks.

"(v) The Board shall by order set forth the reasons for any disapproval under this paragraph. Inaction on any notice, or a Board order determining not to disapprove a proposal to engage in an activity that has previously been authorized by regulation under this paragraph, shall be final and shall not be subject to judical review under this Act or in any other manner. Any company may obtain judicial review pursuant to section 9 of this Act of any Board order not to disapprove a notice filed by such company under this paragraph if such order contains restrictions or conditions.

"(vi) A bank holding company may petition the Board to determine by regulation that a particular activity is closely related to banking. The Board may by regulation prescribe limitations on the conduct of any activity authorized under paragraph (8) or (15) of this subsection consistent with the criteria in clause (iv) of this subparagraph and with safe and sound financial practices. In administering this paragraph, the Board shall promote competition between bank holding companies and other companies engaged in activities closely related to banking.

"(vii) The Board shall not after the date of enactment of this paragraph designate as an activity closely related to banking within the meaning of this paragraph any activity that is described in clauses (i) and (ii) of subparagraph (B) of paragraph (15) of this subsection or that is prohibited to a member bank or to an affiliate of a member bank under sections 16 (12 U.S.C. 24 (Seventh)) or 20 (12 U.S.C. 377) of the Banking Act of 1933, as amended.

"(viii) Notwithstanding any other provision of this Act, if the Board finds that an emergency exists which requires the Board to act immediately on any notice or application under this subsection involving a thrift institution, and the primary Federal regulator of such institution concurs in such finding, the Board may dispense with any notice or other requirement of this subsection.

"(C) For purposes of this paragraph, it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance as a principal, agent, or broker except (i) where the insurance is limited to assuring repayment of the outstanding balance due on a specific extension of credit by a bank holding company or its subsidiary in the event of the death, disability, or involuntary unemployment of the debtor; (ii) in the case of a finance company which is a subsidiary of a bank holding company, where the insurance is also limited to assuring repayment of the outstanding balance on an extension of credit in the event of loss or damage to any property used as collateral on such extension of credit and such extension of credit is not more than an amount equal to $10,000 ($25,000 in the case of an extension of credit which is made to finance the purchase of a residential manufactured home and which is secured by such residential manufactured home) increased by the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published monthly by the Bureau of Labor Statistics for the period beginning on January 1, 1982, and ending on December 31 of the year preceding the year in which such extension of credit is made; (iii) any insurance agency activity in a place that (I) has a population not exceeding five thousand (as shown by the last preceding decennial census), or (II) the bank holding company, after notice and opportunity for a hearing, demonstrates it has inadequate insurance agency facilities; (iv) any insurance agency activity which was engaged in by the bank holding company or any of its subsidiaries on May 1, 1982, or which the Board approved for such company or any of its subsidiaries on or before May 1, 1982, including (I) sales of insurance at new locations of the same bank holding company or the same subsidiary or subsidiaries with respect to which insurance was sold on May 1, 1982, or approved to be sold on or before May 1, 1982, if such new locations are confined to the State in which the principal place of business of the bank holding company is located, any State or States immediately adjacent to such State, and any State or States in which insurance activities were conducted by the bank holding company or any of its subsidiaries on May 1, 1982, or were approved to be conducted by the bank holding company or any of its subsidiaries on or before May 1, 1982, and (II) sales of insurance coverages which may become available after May 1, 1982, so long as those coverages insure against the same types of risks as, or are otherwise functionally equivalent to, coverages sold on May 1, 1982, or approved to be sold on or before May 1, 1982 (for purposes of this subparagraph, activities engaged in or approved by the Board on May 1, 1982, shall include activities carried on subsequent to that date as the result of an application to engage in such activities pending on May 1, 1982, and approved subsequent to that date or of the acquisition by such company pursuant to a binding written contract entered into on or before May 1, 1982, of another company engaged in such activities at the time of the acquisition); (v) any insurance activity where the activity is limited solely to supervising on behalf of insurance underwriters the activities of retail insurance agents who sell (I) fidelity insurance and property and casualty insurance on the real and personal property used in the operations of the bank holding company or any of its subsidiaries, and (II) group insurance that protects the employees of the bank holding company or any of its subsidiaries; (vi) any insurance agency activity engaged in by a bank holding company, or any of its subsidiaries, which bank holding company has total assets of

$50,000,000 or less: *Provided, however,* That such a bank holding company and its subsidiaries may not engage in the sale of life insurance or annuities except as provided in clauses (i), (ii), or (iii) of this subparagraph; or (vii) where the activity is performed, or shares of the company involved are owned, directly or indirectly, by a bank holding company which is registered with the Board of Governors of the Federal Reserve System and which, prior to January 1, 1971, was engaged, directly or indirectly, in insurance agency activities as a consequence of approval by the Board prior to January 1, 1971.".

(2) by adding following paragraph (14) the following new paragraph (15):

"(15) (A) shares of any securities affiliate the activities of which consist of:

"(i) dealing in or underwriting obligations issued or guaranteed by or on behalf of a State or any political subdivision thereof or any agency or instrumentality of either of the foregoing, except industrial development bonds as defined in section 103(b)(2) of the Internal Revenue Code of 1954, as amended: *Provided, however,* That a securities affiliate may deal in and underwrite such industrial development bonds, the interest on which is exempt from Federal income tax under section 103(a) of the Internal Revenue Code of 1954, as amended, if: (I) a State, territory, possession of the United States, or any political subdivision of the foregoing, or the District of Columbia pledges its full faith and credit for the payment of all principal and interest on such bonds or (II) the issuer, or the State or local governmental unit on behalf of which the industrial development bonds were issued, is considered the sole owner, for Federal income tax purposes, of the facility with respect to which financing is to be provided from the proceeds of such industrial development bonds;

"(ii) dealing in or underwriting securities backed by pools of residential mortgage loans;

"(iii) organizing, sponsoring, operating, controlling, providing investment advice to, or underwriting, distributing, or selling the shares of an investment company, as such term is defined in section 3 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-3); or

"(iv) any securities or securities-related activity that a national or state member bank is not prohibited by law from conducting directly.

"(B) No bank holding company that engages in any activity described in clauses (i), (ii), or (iii) of subparagraph (A) of this paragraph through a securities affiliate shall, after one year from the date on which any such securities affiliate first engages in any of such activities, permit a bank or insured institution controlled by such holding company to engage, directly or indirectly, in the United States in such activities (other than organizing, sponsoring, operating, controlling or providing investment advice to a closed-end investment company) or in any of the following activities: (i) dealing in or underwriting any obligation of the United States and any other obligation listed in paragraph Seventh of section 5136 of the Revised Statutes of the United States, as amended (12 U.S.C. 24), and (ii) purchasing and selling securities and stock as agent. For purposes of this subparagraph, the Board may, by regulation or order, determine additional securities or securities-related activities in which such bank or insured institution may not engage. No rule, regulation or order of the Board, however, shall prohibit a bank or insured institution from engaging in those securities or securities-related activities that are necessary or incidental to the financing of such bank or insured institution or to the investment of its funds. In the event that a securities affiliate controlled by a bank holding company terminates all of the activities specified in clauses (i), (ii), and (iii) of subparagraph (A) of this paragraph, any bank or insured institution that is controlled by such bank holding company may conduct any securities or securities-related activities that it is authorized by law to conduct.

"(C) A bank holding company seeking to acquire shares of a securities affiliate or engage directly in securities or securities-related activities pursuant to this paragraph shall comply with the prior notification and other requirements and limitations of paragraph (8) of this subsection."; and

(3) by deleting the penultimate sentence thereof, which begins "In the event".

SEC. 6. Subsection 5(c) of the Bank Holding Company Act, as amended (12 U.S.C. 1844(c)), is hereby amended to read as follows:

"(c)(1) The Board from time to time may require reports under oath, in such scope and detail as it may determine, of a bank holding company and each subsidiary thereof to keep the Board informed as to whether such companies are complying with the provisions of this Act and regulations and orders issued thereunder.

"(2) Except where the Board determines that a lesser reporting requirement is appropriate, the Board shall accept in fulfillment of the reporting requirements established pursuant to this subsection for nonbank subsidiaries separate reports consisting of: (A) for companies subject to the reporting requirements of section 17 of the Securities Exchange Act of 1934 (15 U.S.C. 78q), the same information required to be submitted to the Securities and Exchange Commission under such section (and the rules and regulations thereunder) at the same time such information is so submitted; and (B) for all other companies the same information as would be required to be submitted under section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) (and the rules and regulations thereunder) by companies subject to the reporting requirements of such Act, that are engaged in the same or similar lines of business, not more frequently than quarterly. In particular circumstances, the Board may require additional information in order to fulfill its responsibilities under this Act.

"(3) The Board may make examinations of each bank holding company and each subsidiary thereof, the cost of which may be assessed against, and paid by, such holding company. The Board shall, however, insofar as possible, minimize the scope and frequency of examinations of nonbank subsidiaries of a bank holding company by utilizing, where feasible, reports of applicable regulatory agencies or other bodies public or private, and by directing, to the extent feasible, the focus of such examinations to the activities or financial condition of such nonbank subsidiaries that may have a materially adverse effect on the safety and soundness or financial condition of a subsidiary bank of the bank holding company.".

SEC. 7. Section 7 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1846), is hereby amended by striking out the period at the end thereof and inserting the following: ": *Provided, however,* That no State shall prohibit the affiliation of a national banking association, as such term is used in section 21 of this title, with a company engaged only in one or more of the activities described in paragraphs (8) and (15) of subsection 4(c) of this Act.".

SEC. 8. Section 11 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1849), is hereby amended by inserting after the fourth sentence of subsection (b) thereof the following new sentence: "The Board may shorten or eliminate this thirty day period with the consent of the Attorney General.".

AMENDMENTS TO THE BANK MERGER ACT OF 1966

SEC. 9. Section 18(c) of the Bank Merger Act of 1966 12 U.S.C. 1828(c), is hereby amended by inserting at the end of paragraph (6) thereof the following new sentence: "The responsible agency may shorten or eliminate this thirty-day period with the consent of the Attorney General.".

AMENDMENTS TO THE BANKING ACT OF 1933

SEC. 10. Section 20 of the Banking Act of 1933, as amended (12 U.S.C. 377), is hereby amended by adding the following new paragraph at the end of the first paragraph of such section:

"Notwithstanding any other provision of this section, a member bank may be affiliated in any manner described in subsection (b) of section 221a of this title with a securities affiliate as defined in section 2(j) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(j)).".

SEC. 11. Paragraph 1 of subsection 21(a) of the Banking Act of 1933, as amended (12 U.S.C. 378(a)(1)), is hereby amended by deleting the word "or" and replacing the semicolon at the end thereof with a period and by adding the following new sentence at the end thereof: "The prohibitions of this paragraph shall apply to any subsidiary (as defined in 12 U.S.C. 1841(d)) of any firm, corporation, association, business trust, or other similar organization engaged in the business of receiving deposits as described herein. A subsidiary of such organization, the activities of which become unlawful as a result of the enactment of the Depository Institutions Holding Company Act Amendments of 1983 may continue its existing activities for a period of two years after the date of enactment of such act; or".

SEC. 12. Section 32 of the Banking Act of 1933, as amended (12 U.S.C. 78), is hereby amended by adding the following sentence at the end thereof: "Notwithstanding any other provision of this section, an officer, director, or employee of any member bank may serve at the same time as an officer, director, or employee of any securities affiliates with which the member bank is affiliated. The term 'securities affiliate' shall have the meaning ascribed to it in section 2(j) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(j)).".

AMENDMENTS TO THE FEDERAL DEPOSIT INSURANCE ACT

SEC. 13. Subsection 18(j) of the Federal Deposit Insurance Act (12 U.S.C. 1828(j)) is amended:

(1) by redesignating paragraphs (3) and (4) as paragraphs (4) and (5), respectively, and by adding the following new paragraph (3):

"(3) The provisions of section 20 of the Banking Act of 1933, as amended (12 U.S.C. 377), relating to affiliations between member banks and organizations engaged principally in certain securities activities, and the provisions of section 32 of the Banking Act of 1933, as amended (12 U.S.C. 78), relating to certain officer, director or employee relationships involving a member bank and a person or organization primarily engaged in certain securities activities, shall be applicable to every nonmember insured bank in the same manner and to the same extent as if such nonmember insured bank were a member bank. An affiliation or officer, director or employee relationship that becomes unlawful as a result of the enactment of this paragraph may continue for a period of two years after the date of enactment of this paragraph. The provisions of this paragraph shall not apply to any foreign bank, as defined in subsection 1(7) of the International Banking Act of 1978, having an insured branch in the United States with respect to any affiliation between such bank and any company organized under the laws of a foreign country that is not engaged in business in the United States except as an incident to its activities outside the United States, and shall not apply to any officer, director, or employee of any such foreign bank, but shall apply to officers and employees of the insured branch."; and

(2) by inserting after the words in the first sentence of paragraph (4)(A), as so redesignated under paragraph (1) of this section, "or any lawful regulations issued pursuant thereto," the following words: "or any provision of section 20 of the Banking Act of 1933, as amended,".

PROHIBITION ON CERTAIN ACTIVITIES BY DEPOSITORY INSTITUTIONS

SEC. 14. Section 2 of Public Law 93–100 (12 U.S.C. 1832) is amended by adding at the end thereof the following new subsection (d):

"(d) No State-chartered depository institution may commence, either directly or indirectly, any activity unless (1) such activity was authorized for that type of institution explicitly and not by implication by a State statute adopted, or by an interpretation promulgated thereunder, prior to January 1, 1983; (2) such activity is permitted under section 4(c)(8) of the Bank Holding Company Act for a bank holding company subject to all applicable limitations; or (3) such activity is explicitly authorized by a State statute, or interpretation promulgated thereunder, and is performed exclusively in the State authorizing such activity for residents of that State. This section does not authorize the conduct of any activity prohibited to a State-chartered depository institutions under sections 20 or 21 of the Glass-Steagall Act. Nothing in this section shall prohibit a State-chartered savings and loan association or savings bank from engaging in any activity expressly permitted for a Federal savings and loan association or Federal savings bank pursuant to the Garn-St Germain Depository Institutions Act of 1982 (Public Law 97–320). Any State-chartered depository institution that after

June 23, 1983, commenced any activity, directly or indirectly, that would have been prohibited by this subsection if commenced after enactment of this subsection shall immediately terminate such activity.".

AMENDMENTS TO THE SECURITIES ACT OF 1933

SEC. 15. Section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77d), is hereby amended by adding a new paragraph (7) at the end thereof:

"(7) Transactions involving offers or sales of equity securities in connection with the acquisition of a bank by a company under the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.), if such acquisition occurs solely as part of a reorganization in which a person or group of persons exchange their shares of a bank for shares of a newly formed bank holding company and receive, after such reorganization, substantially the same proportional share interest in the holding company as they held in the bank, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under State or Federal law.".

AMENDMENTS TO THE SECURITIES EXCHANGE ACT

SEC. 16. Subparagraphs (i), (ii), and (iii) of paragraph (34)(A) of subsection 3(a) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78c(a)(34)(A)), are each hereby amended by inserting immediately before the semicolons at the end thereof, the words, "other than a securities affiliate as defined in section 2(j) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(j)).

SEC. 17. Paragraph (b)(1) of section 15B of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78o-4(b)(1)), is hereby amended by striking the word "subsidiaries" in parts (B) and (C) thereof and replacing it with the word, "affiliates".

AMENDMENTS TO THE FEDERAL RESERVE ACT

SEC. 18. (a) The Federal Reserve Act is amended by adding new section 23B immediately following section 23A (12 U.S.C. 371c) thereof to read as follows:

"SEC. 23B. RESTRICTIONS ON TRANSACTIONS WITH AFFILIATES.—(a) A member bank and its subsidiaries may engage in any of the following transactions, only on terms and under circumstances, including credit standards, that are substantially the same as, or at least as favorable to such bank or its subsidiary as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies or, in the absence of comparable transactions, those terms and circumstances that in good faith would be offered to, or would apply to nonaffiliated companies:

"(1) any covered transaction, as defined in section 23A, with an affiliate;

"(2) the sale of securities or other assets, including assets subject to an agreement to repurchase, to an affiliate;

"(3) the payment of money or the furnishing of services to an affiliate, under contract, a lease, or otherwise;

"(4) any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person; or

"(5) any transaction or series of transactions with a third party, (A) if an affiliate has a financial interest in the third party, or (B) if an affiliate is a participant in such transaction or series of transactions.

For the purposes of this subsection, any transaction by a member bank with any person shall be deemed to be a transaction with an affiliate of such bank to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, such affiliate.

"(b) A member bank and the affiliates of such bank shall not publish any advertisement or enter into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates; however, a member bank and its affiliates may use similar names.

"(c) A member bank and any subsidiary of such bank:

"(1) shall not purchase as fiduciary any securities or other assets from any affiliate unless such purchases are permitted under the instrument creating the fiduciary relationship, by court order, or by law of the jurisdiction under which the trust is administered; and

"(2) whether acting as principal or fiduciary, shall not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security a principal underwriter of which is an affiliate of such bank; except that this prohibition shall not apply where the purchase of such securities has been approved, prior to the time at which such securities are initially offered for sale to the public, by a majority of the directors of the bank who are not officers or employees of the bank or any affiliate thereof. For the purpose of this paragraph, the term 'security' means a 'security' as defined in section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)); and the term 'principal underwriter' means any underwriter who, in connection with a primary distribution of securities, (A) is in privity of contract with the issuer or an affiliated person of the issuer; (B) acting alone or in concert with one or more persons, initiates or directs the formation of an underwriting syndicate; or (C) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

"(d) For the purpose of this section:

"(1) the term 'affiliate' means an 'affiliate' as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c) excluding a bank; and

"(2) the terms 'bank', 'subsidiary', 'person', and 'security' (other than security as used in subsection (c)) have the same meanings given to them in section 23A of the Federal Reserve Act (12 U.S.C. 371c).

"(e) The Board may prescribe rules and regulations to administer and carry out the purposes of this section, including rules or regulations to (1) further define terms used in this section; (2) exempt transactions or relationships from the requirements of this section; or (3) exclude from the definition of 'affiliate' in this section any subsidiary of a bank holding company, if the Board finds such exemptions or exclusions to be in the public interest and consistent with the purposes of this section.".

(b) Section 18(j) of the Federal Deposit Insurance Act (12 U.S.C. 1828(j)) is hereby amended:

(1) by inserting "and section 23B" after "section 23A" at each place it appears in paragraph (1); and

(2) by inserting ", 23B," after "23A" in paragraph (4)(A), as so redesignated under paragraph (1) of section B of this Act.

AMENDMENTS TO THE INVESTMENT COMPANY AND INVESTMENT ADVISERS ACTS OF 1940

SEC. 19. (a) Subsection 17(f) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a–17(f)), is hereby amended by adding after the words "unit investment trusts": "*Provided, however,* That any registered management company that is organized, sponsored, operated or controlled by, or which receives investment advice from, any securities affiliate, as defined in section 2(j) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(j)), may place and maintain its securities and similar investments in the custody of a bank which is affiliated with such securities affiliate only with the prior approval of the Commission.".

(b) Subsection 26(a)(1) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a–26(a)(1)), is hereby amended by adding after the words "so published);": "*Provided, however,* That, except with the prior approval of the Commission, it shall be unlawful for such trust indenture, agreement of custodianship, or other instrument to designate as trustee or custodian any bank which is affiliated with a securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(j)), which organizes, sponsors, operates or controls such registered unit investment trust.".

(c) Subsection 27(c)(2) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a–27(c)(2)), is hereby amended by adding after the words "trust indentures of unit investment trusts": "*Provided, however,* That, except with the prior approval of the Commission, it shall be unlawful to deposit such proceeds with any bank which is affiliated with a securities affiliate, as defined in section 2(j) of the Bank Holding Company Act of 1956 as amended (12 U.S.C. 1841(j)), which organizes, sponsors, operates, controls or renders investment advice to such registered investment company.".

(d) Subsection 202(a)(11) of the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b–2(a)(11)), is hereby amended by inserting after the words "bank holding company" the following: "(other than a bank holding company which is a securities affiliate)".

AMENDMENTS TO BANK HOLDING COMPANY ACT AMENDMENTS OF 1970

SEC. 20. Section 105 of the Bank Holding Company Act Amendments of 1970, (12 U.S.C. 1850), is hereby amended by deleting the words ", to engage directly or indirectly in a nonbanking activity pursuant to section 4 of such Act.".

SEC. 21. Section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972, et seq.), is hereby amended by adding new subsection (i) at the end thereof to read as follows:

"(i) Any action for injunctive relief that may be commenced by any person pursuant to section 1976 of this title may be commenced on the behalf of such person by any trade association of which such person is a member: *Provided,* That any such action commenced by a trade association shall be subject to the same requirements, limitations, and conditions as would be applicable had such action been commenced by any such person pursuant to section 1976 of this title.".

AMENDMENTS TO THE SAVINGS AND LOAN HOLDING COMPANY AMENDMENTS OF 1967

SEC. 22. Section 408 of the National Housing Act (12 U.S.C. 1730a), is hereby amended by deleting subsection (n) thereof and replacing it with the following new subsection (n):

"(n) In the event that (A) an insured institution that is owned or controlled by a unitary savings and loan holding company devotes less than 60 per centum of its assets to residential mortgages and related investments on average during the year; (B) such subsidiary insured institution's services or products are offered to or marketed through such holding company or its other subsidiaries; or (C) the services or products of such holding company or its other subsidiaries are offered to or marketed through such subsidiary insured institution, such unitary savings and loan holding company may not thereafter commence, or continue for more than three years, any business activity not permissible for a multiple savings and loan holding company under paragraph (2) of this subsection. For purposes of determining compliance with the three-year period described in the preceding sentence, the last sentence of paragraph (2) of this subsection shall be inapplicable. For the purposes of this section, the term "related investments" means (i) securities backed by residential mortgages; (ii) retail mobile home loans; (iii) home improvement loans; (iv) loans to finance the construction of residential properties; and (v) investments in service corporations except that such investments shall be reduced by an amount proportionate to the amount of such corporation's assets that are not residential mortgages or related investments as defined in this section.".

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Financial Services Competitive Equity Act, S. 2181

Title-by-Title Analysis

The purpose of this legislation is to provide a comprehensive Federal statutory framework for the regulation of bank and thrift holding companies. In order to promote increased competition, this bill provides a mechanism for expanding the permissible activities for depository institution holding companies to include those of a financial nature; insurance underwriting and brokerage; real estate investment, development and brokerage, with limitations; and certain securities activities. The bill permits these new activities to be conducted only by the holding company itself or by a subsidiary of the holding company.

This bill, S. 2181, sponsored by Senator Jake Garn, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, is an amended form of S. 1609, with nine additional titles. Title I of S. 2181 is nearly identical to S. 1609, a bill submitted on behalf of the Treasury Department. S. 2181 has not deleted any of the text of S. 1609, except for the provision defining banks to include institutions eligible to be insured by the FDIC, which was deleted in Subsection 104(a) of S. 2181. The other nine titles of S. 2181 are legislative proposals which were separately introduced by various Senators last year.

Title I

Section 101 - Bank Affiliation With a Securities Affiliate

Subsection 101(a) Subsection 101(a) amends Section 20 of the Banking Act of 1933 (12 U.S.C. 377) to allow a member bank to be affiliated with a depository institution securities affiliate (defined in Subsection 104(a) of the bill). Although this provision permits such affiliation, it does not permit the member bank to own shares of such an affiliate, or otherwise to engage in securities activities. Thus, the activities authorized for a depository institution securities affiliate must be conducted either by the bank's parent holding company or by a separate subsidiary of the holding company.

Although Section 20 of the Banking Act of 1933 (the Glass-Steagall Act) does not apply to nonmember banks, Section 4 of the Bank Holding Company Act of 1956 (the "Bank Holding Company Act") has been applied to prohibit a general securities firm from becoming a subsidiary of a bank holding company and, thereby, from affiliating with any subsidiary bank (including a member bank) of a bank holding company. Accordingly, as provided in Subsection 104(e), this bill amends the Bank Holding Company Act to allow a bank holding company to acquire shares of a depository institution securities affiliate.

Subsection 101(b) Subsection 101(b) amends Section 32 of the Banking Act of 1933 (12 U.S.C. 78) to allow an officer, director, or employee of a member bank to serve at the same time as an officer, director, or employee of its depository institution securities affiliate or affiliates. Existing restrictions continue to apply to prevent such an interlocking relationship with a nonaffiliated depository institution securities affiliate or any other firm engaged in securities activities.

Section 102 - Securities Act Exemption for Internal Reorganizations

Section 102 amends the Securities Act of 1933 to exempt from the registration requirements of that Act the issuance of a company's shares in connection with a simple reorganization in which a company becomes the parent of a bank or thrift institution. Therefore, the filing of a registration statement will not be required by the Act where a person or group of persons owning the shares of a bank or a thrift institution transfers those shares to a newly formed holding company and receives substantially the same proportional share interest in the holding company that the person or group held in the depository institution immediately prior to the reorganization. The amendment is intended to reduce the time and expense involved in forming a holding company where the underlying ownership does not change.

Section 103 - Supervisory Authority Over Bank Municipal Securities Activities

Subsection 103(a) Subsection 103(a) amends the definition of "appropriate regulatory agency" in the Securities Exchange Act of 1934 ("Securities Exchange Act") so that the Securities and Exchange Commission ("SEC") is the appropriate regulatory agency for enforcing a depository institution securities affiliate's compliance with the statutory and regulatory requirements governing transactions in municipal securities.

Subsection 103(b) Subsection 103(b) amends Section 15B of the Securities Exchange Act, which establishes the composition of the Municipal Securities Rulemaking Board to provide depository institution securities affiliates with representation on the MSRB equivalent to that enjoyed by other municipal securities dealers and bankers engaged in the municipal securities business.

Section 104 - Definitions, Consumer Banks, and Powers of Bank Holding Companies

Subsection 104(a) Subsection 104(a) amends the definitions used in the Bank Holding Company Act by modifying the meaning of "bank" and by adding the terms "depository institution securities affiliate," "consumer bank," "commercial loans," "depository institution holding company," "depository institution," "savings and loan holding company," and "insured institution."

The term "bank" is modified to mean: (1) an insured bank as that term is defined in the Federal Deposit Insurance Act (12 U.S.C. 1813(h)); or (2) any institution, whether organized under the laws of the United States, any state or the District of Columbia or any United States territory, that both accepts deposits that are withdrawable by a check or similar means and engages in the business of making commercial loans. The term bank does not include, however, a consumer bank (defined below) or Morris Plan bank, industrial bank or industrial loan company, operating under State law that does not both engage in the business of making commercial loans and accept demand deposits, a foreign bank having an insured branch, or an insured institution (as defined in 12 U.S.C. 1730 (a)(a)(1). Furthermore, this bill continues to exempt Edge Act banks and organizations whose only United States business is an incident of their activities outside the United States. This expanded definition of bank brings federally insured nonbank banks, except consumer banks, under the jurisdiction of the Bank Holding Company Act.

The Act creates a new form of bank, the "consumer bank", and defines it as any institution that would otherwise be within the definition of "bank" under the Bank Holding Company Act except that it does not engage in the business of making commercial loans. Consumer banks may extend personal loans, residential mortgages, credit card loans, invest in commercial paper, certificates of deposit, and mortgage-backed or government securities, and invest up to five percent of its assets in inventory, small business, and similar loans.

The term "depository institution securities affiliate" means any corporation that (1) engages in the United States in one or more of the activities authorized under Subsection 104(e) of the bill, and (2) is either a broker or dealer within the meaning of the Securities Exchange Act or an investment adviser within the meaning of the Investment Advisers Act of 1940.

For purposes of the Bank Holding Company Act, Subsection 104(a) of the bill defines the term "depository institution holding company" to mean bank holding company and the term "depository institution" to mean bank. Similarly, for the purposes of the Savings and Loan Holding Company Act, Subsection 108(a) of this bill defines the term "depository institution holding company" to mean savings and loan holding company, and the term "depository institution" to mean insured institution. As a result, a depository institution securities affiliate could be affiliated with either a bank or an insured thrift institution; a depository institution holding company could be either a bank or a savings and loan holding company.

Finally, Subsection 104(a) defines "savings and loan holding company" and "insured institution" for purposes of the Bank Holding Company Act as they are defined in the Savings and Loan Holding Company Amendments of 1967.

Subsection 104(b) Subsection 104(b) amends Subsection 3(a) of the Bank Holding Company ACt to provide a simplified process for the formation of a bank holding company in which a person or group of persons owning bank shares transfers such shares to a newly formed holding company and receives substantially the same proportional share interests in the holding company that were held in the bank prior to the holding company's formation, provided that no other organizational change is implemented as part of such holding company formation.

Under this approach, the formation of a holding company would automatically be approved if: (1) thirty days prior notice is given to the Federal Reserve Board; (2) the proposed bank holding company meets the capital and other financial standards established by regulation by the Federal Reserve Board; and (3) the proposed bank holding company does not engage, at the time of the reorganization, in any activities other than banking or managing or controlling banks.

Subsection 3 is further amended by adding a new subsection (f) establishing interstate operating standards for consumer banks. These standards would apply to all types of companies, including bank holding companies, owning consumer banks. The new subsection would also cover companies engaged in consumer banking whether or not such activities were commenced prior to July 1, 1983.

The geographical standards are designed to permit a company to own consumer banks in states where the company operated a consumer bank or banks prior to July 1, 1983, in states which permit interstate banking operations (commercial banking or consumer banking) and in states which permit companies to own industrial loan companies.

Subsection 104(c) Subsection 104(c) amends paragraph 4(a)(2) of the Bank Holding Company Act to expand the types of activities in which a bank holding company may engage directly (e.g. depository institutions securities affiliates) and to provide certain grandfather privileges for bank holding companies.

Although the Bank Holding Company Act generally prohibits a bank holding company from engaging in nonbanking activities directly, paragraph 4(a)(2) of that Act authorizes a holding company to engage directly in those activities permitted under paragraph 4(c)(8) of the Act. Since Subsection 104(d) of the bill expands paragraph 4(c)(8) activities, all of these newly permitted activities may be conducted in the holding company directly.

Subsection 104(c) also sets forth certain grandfather rights for companies that acquired so-called "nonbank banks" prior to July 1, 1983. No grandfather rights are provided for any company that acquires a nonbank bank after July 1, 1983. A company that owned a nonbank bank on or prior to July 1, 1983 may continue to operate its nonbank bank, provided that the nonbank bank does not both accept demand deposits and "engage in the business of making commercial loans" (as that term is defined in Subsection 104(a)). In addition, such a company may continue to conduct and expand any activity, but only if it was legally engaged in that activity on July 1, 1983, and continuously thereafter. Any expansion of an activity permissible for bank holding companies is, however, subject to any conditions, limitations, or requirements of the Bank Holding Company Act. A grandfathered company automatically loses its grandfather privileges if:

(1) it acquires control of an additional bank or insured institution, or if its existing nonbank bank both accepts demand deposits and makes commercial loans; or (2) it begins, after July 1, 1983, to engage in any activities, other than those permissible for a bank holding company, that were not grandfathered pursuant to this Section.

Subsection 104(d) Subsection 104(d) amends Subsection 4(c) of the Bank Holding Company Act by deleting the current paragraph (8), which permits bank holding companies, after notice and opportunity for hearing and subject to prior approval by the Federal Reserve Board, to engage in activities closely related to banking. Subsection 104(d) replaces that paragraph (8) with a new paragraph (8), which permits bank holding companies, after notice and subject to disapproval by the Federal Reserve Board, to engage in the following: (1) ownership of thrift institutions; (2) ownership of consumer banks; (3) activities determined by the Federal Reserve Board to be of a financial nature; (4) activities determined by the Board to be closely related to banking or managing or controlling banks; (5) insurance underwriting or brokerage; and (6) real estate investment, development or brokerage (subject to the limitations that no more than five percent of the bank holding company's primary capital be devoted to real estate investment and development and that no form of construction activity be permitted).

Generally, the bank holding company must submit a notice to the Board 60 days in advance of engaging in any of these activities. However, no notice is required where a bank holding company opens offices de novo or changes the location of existing offices with no change of activities. The Board will, by regulation, prescribe the information that must be submitted, including information concerning the managerial and financial resources of the bank holding company; and compliance with the restrictions on large-bank acquisitions set forth in Subparagraph (C) of the new paragraph 4(c)(8). If additional information, not described by regulation, is required for any particular notice, the Board may suspend the notice process, but then must act to disapprove the proposal within 30 days after the additional information is submitted.

Subsection 104(d) requires the Board, within 180 days after the effective date of this Act, to promulgate regulations listing and describing specific activities that are of a financial nature and specific activities that are closely related to banking, and permitting bank holding companies, after notice and subject to the conditions of this section, to engage in those activities.

The Board is further directed to revise periodically its regulations to continue to promote expanded competition among all companies engaged in activities of a financial nature and to permit holding companies to engage in additional activities that are closely related to banking.

The Board, however, is prohibited from authorizing activities pursuant to this Subsection that are of the kind described in paragraph 15 of Subsection 4(c) of the Bank Holding Company Act, or that are prohibited under Sections 16 and 20 of the Banking Act of 1933 (12 U.S.C. 24 (Seventh) and 377) as amended by this bill. The prohibition against authorizing the activities specified in paragraph 15 is to ensure that any securities activities conducted by a bank holding company are conducted only subject to the conditions and requirements of paragraph 15 of Subsection 4(c) of the Bank Holding Company Act.

This bill contains no general limitation on the extent to which a bank holding company may engage, either directly or through a subsidiary, in insurance underwriting and brokerage activities. However, the Federal Reserve Board is authorized to prescribe limitations for the conduct of such activities consistent with the statutory criteria specified in paragraph 8 of Subsection 4(c) of the Bank Holding Company Act and consistent with safe and sound financial practices. Moreover, Section 107 contains other restrictions on insurance activities.

In authorizing bank holding companies, either directly or through a subsidiary, to engage in real estate investment, development or brokerage, Subsection 104(d) of the bill limits the bank holding company's capital investment in its real estate development and investment activities to no more than five percent of its primary capital. Real estate brokerage activities are not so limited. It is the intent of this bill that property management be considered a permissible real estate brokerage activity for a bank holding company. Construction activity, however, will not be permissible.

Subsection 104(d) of this bill authorizes bank holding companies to acquire one or more thrift institutions. (The bill does not authorize a bank holding company to engage directly in the activities of a thrift institution). Any acquisition under this new authority is also subject to all of the limitations, conditions and requirements of the Savings and Loan Holding Company Act, to the Douglas Amendment of the Bank Holding Company Act, and to the McFadden Act. Thus, for example, both the FSLIC and the Board have authority to disapprove any such acquisition; but it is expected that the Board will defer to the FSLIC as the primary regulator of the insured thrift in the area of the financial safety and soundness of such subsidiary.

Subsection 104(e). Subsection 104(e) adds a new exemption to Subsection 4(c) of the Bank Holding Company Act to permit bank holding companies to operate a depository institution securities affiliate. As explained in Section 104(c) herein, such depository institution securities affiliate activities may be conducted by the bank holding company directly as well as through its nonbank subsidiary.

Subparagraph (i) of Subsection 104(e) prohibits any bank holding company that establishes or acquires a securities affiliate pursuant to this Section, or that engages in securities affiliate activities pursuant to Section 104(c) and this Section, from permitting any of its subsidiary banks to engage, directly or through a subsidiary, in any securities activity one year after the date the securities affiliate first engages in any of the specified securities activities described in subparagraph (iii). The activities that are not permissible for a bank subsidiary, and which therefore may be conducted only by the securities affiliate, include the activities specified in subparagraph (iii) described below and the following activities which are authorized under 12 U.S.C. 24 (Seventh) for banks: securities brokerage activities and dealing in and underwriting (1) obligations of the United States, (2) general obligations of any state or local government, and (3) other obligations listed in paragraph Seventh of 12 U.S.C. 24.

The Federal Reserve Board is authorized by subparagraph (i) of Section 104(e) to prescribe rules and regulations identifying any securities and securities-related activities in which a subsidiary bank of a holding company may not engage one year after the date its securites affiliate first begins engaging in any activities described in subparagraph (iii). However, this authority does not extend to, and the bill is not intended to affect, the normal funding and investment practices of depository institutions. Accordingly, for example, a depository institution may continue to purchase and sell investment securities for its own account. It is intended that, in the case of brokerage transactions, only the securities affiliate would be permitted to offer securities brokerage services to customers. Bank services such as custodian activities, however, do not constitute securities brokerage services, and it is intended that such services may continue to be conducted in the bank to the extent permitted by law. It is also intended that banks may continue to engage in advisory activities in connection with the private placement of securities and that such activities need not be transferred to the securities affiliate.

Subparagraph (i) further states that in the event a bank holding company terminates the subparagraph (iii) activities of its depository institution securities affiliate, its bank subsidiary or subsidiaries may conduct (through the bank itself or through a subsidiary) any activities that a bank is authorized by law to conduct.

Under subparagraph (ii) of Subsection 104(e), a depository institution securities affiliate is authorized to conduct all of the securities and securities-related activities that a national bank is not prohibited from conducting under Federal law.

Subparagraph (iii) of Subsection 104(e) specifies activities that may be conducted by a securities affiliate, but that may not be conducted by a bank one year after the date its securities affiliate first begins engaging in any activities described in such subparagraph (iii). The activities specified in subparagraph (iii) include: dealing in and underwriting obligations issued or guaranteed by state or local governments, except most industrial development bonds; */ organizing, sponsoring, operating, and controlling an investment company and advising such a company; **/ underwriting and selling securities of any investment company; and underwriting and selling mortgage-backed securities.

All transactions between a bank and its depository institution securities affiliate are subject to the restrictions on interaffiliate transactions contained in Sections 23A and 23B of the Federal Reserve Act. This is discussed further under Section 105 herein.

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*/ While there is a general prohibition against dealing in and underwriting industrial development bonds, there are two situations in which depository institution securities affiliates may deal in and underwrite tax-exempt industrial development bonds: (1) if either a state or local government pledges its full faith and credit to guarantee payment of all principal and interest on such bonds; or (2) if the issuer (or the governmental unit on whose behalf the bonds are issued), and only the issuer, is considered to be the sole owner of the financed facility for Federal income tax purposes.

**/ Pursuant to subparagraph (iii), a securities affiliate is authorized to engage in, and a bank under the circumstances described in subparagraph (i) is prohibited from engaging in, offering investment advisory services to any investment company sponsored or managed by a bank's securities affiliate and to any investment company other than a closed-end investment company. Offering investment advisory services to a closed-end investment company not so sponsored or managed, which is not covered by subparagraph (iii), would be authorized to be offered both by such bank (under current Federal law) and by its securities affiliate (under subparagraph (ii) herein, which permits a securities affiliate to conduct any securities-related activity that a national bank is not prohibited from conducting).

Subsection 108(b) of this bill provides that savings and loan holding companies also may acquire depository institution securities affiliates and may, either at the holding company level or through such affiliate, conduct all of the activities of a depository institution securities affiliate. In interpreting Subsection 108(b) of the bill, the discussion of Subsection 104(e) above is applicable in relevant part to a savings and loan holding company and to an insured thrift institution as if they were, respectively, a bank holding company and a bank.

Subsection 104(f). Subsection 104(f) adds a new exemption from the general prohibitions of Section 4 of the Bank Holding Company Act to permit a bank holding company, subject to standards and limitations established by the Federal Reserve to acquire shares of a company engaged in any activities in which a multiple savings and loan holding company was authorized by law or regulation to engage on July 1, 1983. With respect to engaging in real estate investment and development, however, a bank holding company is subject to the limitation that no more than 5 percent of its primary capital be devoted to such activities and that no construction activities be permitted. As explained in Subsection 104(c), the permissible real estate activities may be conducted by the bank holding company directly or through a subsidiary.

Subsection 104(g). Subsection 104(g) amends the Bank Holding Company Act to minimize the regulatory overlap between the Federal Reserve Board and the SEC with regard to bank holding companies engaged in the securities business. For example, such companies may satisfy the Board's reporting requirements with respect to nonbank subsidiaries by submitting to the Board the same information submitted to the Securities and Exchange Commission under Section 17 of the Securities and Exchange Act.

Subsection 104(d) also adds new paragraphs C and D to its new Subsection 4(c)(8) of the Bank Holding Company Act. Paragraph C, in order to prevent undue economic concentration of financial resources and minimize the risks associated with an expansion of bank holding company powers, bars bank holding companies which control banks with consolidated deposits equal to or greater than 0.30 percent of all domestic deposits in the United States from merging with or acquiring companies engaged in insurance, securities, real estate or other activities permissible under Sections 4(c)(8) or 4(c)(15), if immediately after, and as a result of, the acquisition or merger that bank holding company will have over 25 percent of its consolidated capital invested in any one of those permissible activities. Conversely, it also bars companies engaged in the permissible activities from acquiring or merging with bank holding companies which meet the 0.30 percent deposit test if after, and as a result of, the merger or acquisition the resulting bank holding company engaged in those activities will have over 25 percent of its consolidated assets invested in any one of the permissible activities. The term domestic deposits means deposits booked at banking offices in the United States, and does not include deposits booked at foreign locations or at international banking facilities located inside of the United States.

The effect of these provisions is to limit affiliation between companies engaged in insurance, real estate, and securities activities and other permissible activities and approximately the largest 25 bank holding companies in the United States. The limitations are cumulative, so that each new acquisition must satisfy the prescribed test, but they do not limit internal growth, and only apply to mergers and acquisitions.

Paragraph D subjects bank holding company acquisitions of thrift institutions to Section 3(d) of the Bank Holding Company Act (the Douglas Amendment), which requires that bank holding companies may only acquire subsidiary banks outside the state where its principal business is conducted, in accord with the laws of the state where the bank to be acquired is located. This is intended to prevent bank holding companies from using the newly granted power of owning thrift institutions to subvert the Douglas Amendment. Also, paragraph D subjects insured institutions acquired by bank holding companies to the McFadden Act. Existing branches may be retained, but future branching will be allowed only under the same standards and restrictions that exist in that state for branching by a national bank.

Subsection 104(h). Subsection 104(h) amends Section 7 of the Bank Holding Company Act to provide that no state may prohibit an affiliation between a national banking association and a company engaged in any of the activities authorized by Subsections 104(d), (e), and (f) of this bill. It also provides that no state may authorize banks which it charters to engage in insurance activities outside that state on a basis different from that authorized for such banks within the state.

SECTION 105 - Transactions between Banks and Affiliates

Section 105 amends the Federal Reserve Act (12 U.S.C. 371(c)) by adding new Section 23B, restricting transactions between a member bank and its affiliates. Although Section 23B applies to transactions between a member bank and all of its affiliates, the Federal Reserve Board is authorized to exempt affiliates from the provisions of Section 23B. It is expected that the Board will liberally utilize its authority to exclude subsidiaries engaged in existing nonbank activities. As with Section 23A, new Section 23B is applicable to Federally insured nonmember banks through Section 18(j) of the Federal Deposit Insurance Act. Furthermore, as provided in Subsection 108(c) of this bill, the provisions of Sections 23A and 23B are applicable to transactions between a Federally-insured thrift and its affiliates engaged in newly authorized activities, but are not applicable to qualified thrift lenders.

New Section 23B provides that a member bank and its subsidiaries may engage in certain transactions with any affiliate only if the terms and conditions of the transaction, including credit standards, are substantially the same as, or at least as favorable to the bank as, those prevailing at the time for comparable transactions with nonaffiliated companies. If there are no comparable transactions, the terms and conditions of the transaction must be the same as those that, in good faith, would be offered to or would apply to nonaffiliated companies. Transactions subject to this limitation are:

(1) any covered transaction, as defined in Section 23A, with an affiliate;

(2) a sale of securities or other assets, including assets subject to an agreement to repurchase, to an affiliate;

(3) the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise;

(4) any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person; or

(5) any transaction or series of transactions with a third party if (A) an affiliate has a financial interest in the third party, or (B) an affiliate is a participant in such transaction or series of transactions.

New Section 23B prohibits a bank and its affiliates from advertising, or entering into an agreement suggesting, that the bank is in any way responsible for its affiliates' obligations. It makes clear, however, that a bank and its affiliates may use similar names. Thus, a bank holding company may use a common corporate name or symbol for all of its subsidiaries.

Section 23B prohibits a bank and its subsidiaries from purchasing as fiduciary any securities or other assets from an affiliate, unless such purchases are authorized by the instrument creating the relationship, by court order, or by the law of the jurisdiction under which the trust is administered. The Section also prohibits a bank and its subsidiaries, whether acting as principal or fiduciary, from knowingly either purchasing or acquiring, during the existence of any underwriting or selling syndicate, any obligation for which an affiliate or subsidiary of the member bank is a principal underwriter.

SECTION 106 - Mutual Fund Affiliates

Section 106 amends the Investment Company Act of 1940 to permit an investment company affiliated with a depository institution securities affiliate, but only with the prior approval of the Securities and Exchange Commission, to (1) place or maintain its securities or similar investments in the custody of a bank affiliated with such depository institution securities affiliate; (2) designate any such bank as trustee or custodian; or (3) deposit designated proceeds with any such bank under this Section. The Securities and Exchange Commission has discretion to determine whether and, if so, under what circumstances and conditions, a bank and its affiliated investment company may enter into these three kinds of arrangements.

SECTION 107 - Consumer Protections in Insurance Sales

Section 107 amends Section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972 et seq.) by adding provisions requiring that a bank subsidiary of a bank holding company which solicits or sells insurance, itself or through an affiliate, must inform in writing persons who seek from it credit for which insurance is or may be required that the person may purchase such insurance elsewhere, and that a subsidiary bank may not solicit directly or indirectly credit-related insurance until it informs the person seeking credit, in writing, that the credit sought will be extended. Subsidiary banks may not unreasonably reject suitable alternative insurance contracts, and may not reject such contracts without explaining in writing their reasons, nor make extra charges for handling such contracts or require procedures from insurance agents or brokers different from those required by the bank of its affiliated insurance agents or brokers. They may also not use the information about the customer obtained from an insurance contract to try to persuade the customer to change his insurance to that of the bank without his written consent obtained at a time other than the time of the making of the loan. The customer is granted a right to cancel any credit related insurance purchased from the bank, or an affiliate of the bank, if he notifies the bank within 30 days, and the bank must refund the unearned part of the premium within 20 days of the cancellation.

It also adds a provision which permits a trade association to commence, on behalf of a person who is a member of such trade association, any private right of action for injunctive relief against threatened loss or damage as a result of a violation of the prohibitions against tying arrangements contained in the 1970 Amendments.

SECTION 108 - Savings and Loans Activities and Qualified Thrift Lenders

Subsection 108(a). Subsection 108(a) adds new terms and definitions to the Savings and Loan Holding Company Act. A provision is included to define "insured institution" in the Act to include state chartered, FDIC insured stock savings institutions in the definition, which will have the effect of treating any parent of such an institution as a savings and loan holding company, and excluding such an institution from the definition of "bank" in the amended Section 2(c) of the Bank Holding Company Act. This will result in such institutions being subject to primary federal regulation by the Federal Home Loan Bank Board.

As discussed under Subsection 104(g) of the bill, the term "depository institution securities affiliate" has the same meaning as it has in the Bank Holding Company Act, except that under this provision it may be owned by a savings and loan holding company. The term "depository institution holding company" means savings and loan holding company; the term "depository institution" means an FSLIC-insured thrift or a state chartered stock savings institution insured by the FDIC; and the terms "bank holding company" and "bank" each have the meaning given to them in the Bank Holding Company Act.

Subsection 108(b). Subsection 108(b) amends the Savings and Loan Holding Company Amendments to:

(1) provide a mechanism by which unitary savings and loan holding companies would not be subject to the provisions set forth in Subsection 108(b) restricting savings and loan holding companies whose subsidiaries engage in the new powers granted by this bill.

A unitary savings and loan holding company whose thrift subsidiary is a "qualified thrift lender" would not be subject to the activities provisions of Subsection 108(b). Such a company (a "unitary-QTL") would remain as it is now, with no limits on the parent's activities, but its thrift subsidiary would not obtain the new powers of insurance, real estate, securities and other permissible activities included in this bill.

A QTL is any federally chartered or insured thrift which meets either one of the following tests:

> A. has not more than 25 percent of its assets in the following commercially related loans - direct commercial loans, commercial real estate loans, commercial leasing, and floor planning or inventory loans. (Within the 25 percent figure, federally chartered thrifts would be subject to the commercial investment limits under the Garn-St Germain Act. State chartered thrifts would be subject to any state laws affecting their investment powers.)
>
> B. has more than 60 percent of its assets in residential real estate loans and securities.
>
> To retain its status, a unitary QTL must not fall below the 25 percent or 60 percent requirement, on an average basis, in three out of every four quarters and two out of every three years. If an institution once loses its QTL status, it may not regain it for 5 years. The FSLIC may allow, for good cause, 3 years to comply with these standards.

(2) subject unitary savings and loan holding companies which are not unitary QTL's to the same restrictions on their activities as multiple savings and loan holding companies;

(3) grandfather, under specified circumstances, certain activities of unitary savings and loan holding companies that were in existence on July 1, 1983, and which do not become unitary QTL's;

(4) expand the activities authorized for all savings and loan holding companies, which are not unitary QTL's, to parallel those activities authorized under current law and under this bill for bank holding companies;

(5) provide that the Douglas Amendment will apply to savings and loan holding company acquisitions of a bank, except an

emergency acquisition under Section 3(f) of the Federal Deposit Insurance Act, in order to provide treatment for savings and loan holding companies equal to that for bank holding companies; and

(6) Exempt a company that acquires an FSLIC-insured institution pursuant to the emergency thrift acquisition provisions of the Garn-St Germain Act from the restrictions on business activities generally applicable to savings and loan holding companies under Subsection 108(b).

The grandfathering provisions of Section 108(b) authorize a holding company that was a unitary savings and loan holding company on July 1, 1983, and which does not become a unitary QTL to continue to engage in any activity in which it was lawfully engaged on that date and in which it has been engaged continuously thereafter, regardless of whether or not savings and loan companies may engage in such activities under Federal law. */ Activities that are permissible for savings and loan holding companies, however, may be engaged in or expanded only subject to all the requirements, limitations, and conditions of the Savings and Loan Holding Company Amendments of 1967. Such a holding company (one which was a unitary savings and loan holding company on July 1, 1983 and which is not a unitary QTL) could also continue to expand its existing FSLIC-insured subsidiary or FDIC-insured stock savings institution through branching or new permissible activities or acquire additional insured institutions provided that each such subsidiary continues to qualify as a thrift under the Internal Revenue Code. A grandfathered savings and loan holding company will immediately lose its grandfather privileges when (1) the FSLIC-insured subsidiary or FDIC-insured state chartered savings institution loses such qualification under the Internal Revenue Code; (2) the grandfathered holding company acquires a commercial bank; or (3) the grandfathered holding company commences any new activities, other than those permissible for savings and loan holding companies under this bill. No grandfather privileges are

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*/ Since the Garn-St Germain Act of 1982 already subjected those unitary savings and loan holding companies, whose subsidiary FSLIC-insured institution did not qualify as a domestic building and loan association under Section 7701(a)(19) of the Internal Revenue Code, to the prohibitions applicable to multiple savings and loan holding companies, such unitary savings and loan holding companies are not considered to have become subject to those prohibitions by virtue of the enactment of this bill and are therefore not grandfathered.

provided for any company that acquires an insured institution between July 1, 1983 and the date this legislation becomes effective. Furthermore, the Corporation may terminate these grandfather privileges if, after a hearing, it determines that a termination is necessary to prevent conflicts of interests or unsound practices or is in the public interest.

The second paragraph of Subsection 108(b) of this bill lists the activities that are considered permissible for savings and loan holding companies which are not unitary QTL's. (Because Subsection 108(b) of the bill directly exempts unitary QTL's from the restrictions and requirements it sets forth for savings & loan holding companies unless otherwise indicated, the term savings & loan holding company in this and the following four paragraphs does not include or refer to unitary QTL's.) Although a savings & loan holding company is expected to conform its activities to the list of permissible activities, this paragraph does provide a two-year grace period after the formation of a holding company for such holding company to so conform its activities. This grace period is not available, however, to any company that acquires an insured thrift between July 1, 1983 and the date this bill becomes law. This parallels the two-year grace period provided by law to bank holding companies and is intended to be applied in a parallel manner. The activities listed in Subsection 108(b) as permissible for savings and loan holding companies include the following activities that were permissible under prior law: performing management services for a subsidiary FSLIC-insured thrift; conducting an insurance agency or escrow business; holding, managing, or liquidating a subsidiary FSLIC-insured thrift's assets; holding or managing properties of a FSLIC-insured thrift subsidiary; and acting as trustee under a deed of trust. In addition, Subsection 108(b) adds the following as new permissible activities: insurance underwriting and brokerage (subject to the provisions for a 30 day right of refusal and the other restrictions on insurance sales by bank subsidiaries set forth in Section 107); real estate investment, development, or brokerage (provided that no more than 5 percent of a savings and loan holding company's primary capital may be devoted to real estate investment and development and that no form of construction activity be permitted); the activities of a depository institution securities affiliate in accordance with the limitations contained in the Bank Holding Company Act as provided in Subsection 104(e) of this bill */; activities determined by the

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*/ For purposes of this Subsection, the restrictions set forth in Subsection 104(e) that apply to banks and bank holding companies apply to the same extent to thrifts and savings and loan holding companies, respectively. Accordingly, if a savings and loan holding company forms a depository institution securities affiliate, the holding company must transfer all covered securities activities from its subsidiary insured institution(s) to the securities affiliate even where, for example, the subsidiary may have certain grandfather rights with respect to the securities activities conducted by the insured institution through a service corporation.

Federal Reserve Board to be of a financial nature or closely related to banking; the acquisition of shares of an export trading company in accordance with the relevant provision of the Bank Holding Company Act (except with FSLIC rather than Federal Reserve Board approval) and subject to any rules or conditions for the conduct of this activity established by the Federal Reserve Board; the acquisition of shares of any FDIC-insured bank in accordance with applicable laws; and the activities in which multiple savings and loan holding companies may engage directly on July 1, 1983, provided that in the case of real estate investment and development, a savings and loan holding company may only maintain its investments lawfully held on July 1, 1983, and make additional investments that do not increase the total amount of the holding company's investments in those activities above 5 percent of its primary capital, and that no construction activity may be conducted.*/ The FSLIC may prohibit or limit, however, a savings and loan holding company from engaging in activities determined by the Federal Reserve Board to be of a financial nature or closely related to banking. It is intended, through this list of expanded permissible activities, that savings and loan holding companies be allowed to engage in the same activities authorized for bank holding companies, except that the FSLIC may either prohibit any activity for savings and loan holding companies or place limitations on their conduct.

The savings and loan holding company must submit a notice to the FSLIC 60 days in advance of engaging in any of these activities. No notice is required where a savings and loan holding company opens offices de novo or changes the location of offices with the change of activities.

The FSLIC will, by regulation, prescribe the information that must be submitted and any such required information must be relevant to the nature and scope of the proposed activity and to the FSLIC's consideration of the notice. The FSLIC, in connection with any notice, may consider the same five criteria, discussed under Subsection 104(d) of this bill, that the Federal Reserve Board may consider in evaluating similar activities for bank holding companies.

The FSLIC has the authority, upon consideration of the four criteria noted above, to disapprove the proposal within the statutory time period of 60 days (which period may be extended by the FSLIC for an additional 30 days). The reasons for any disapproval issued by the FSLIC must be set forth by written order.

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*/ The proviso concerning real estate investment and development is intended to grandfather a savings and loan holding company's lawful investments in these real estate activities as of July 1, 1983, but to permit additional investments in real estate investment and development only if, after such investment, no more than 5 percent of the holding company's primary capital is devoted to those activities.

Subsection 108(b) of this bill authorizes savings and loan holding companies to acquire one or more banks. Any acquisition under this new authority is also subject to all of the limitations, conditions and requirements of the Bank Holding Company Act, including section 3(d), the Douglas Amendment. Thus, for example, both the FSLIC and the Federal Reserve Board have authority to disapprove any such acquisition. Furthermore, it is expected that the FSLIC will defer to the primary federal regulator of the bank i.e., the Federal Reserve Board, FDIC or Comptroller of the Currency, in the area of the financial safety and soundness of a subsidiary bank of the holding company.

Subsection 108(b), in order to prevent excessive concentration of economic assets and minimize the risks associated with nonthrift activities, amends Subsection C of the Savings and Loan Holding Company Act in the same manner as Subsection 104(b) amends the Bank Holding Company Act, and imposes the same requirements, i.e. that if a savings and loan holding company with consolidated deposits equal to or greater than 0.30 per cent of all U.S. domestic deposits acquires or is acquired by any company engaged in insurance, real estate or securities or other permissible activities, if after and because of the acquisition, that new company will have over 25 per cent of its consolidated assets invested in any one of those permissible activities, the acquisition will not be approved. The limitations are cumulative but they do not limit internal growth. (see title-by-title analysis of Subsection 104(d))

Subsection 108(c). Subsection 108(c) exempts, from the prohibitions against interaffiliate transactions set forth in the Savings and Loan Holding Company Amendments, transactions between FSLIC-insured thrifts and their affiliates engaged in any of the activities added to the list of permissible savings and loan holding company activities under this bill. It also subjects such transactions to the limitations of Sections 23A and 23B of the Federal Reserve Act as if the FSLIC-insured thrift were a member bank. The FSLIC is authorized to promulgate rules and regulations with respect to Sections 23A and 23B in order to define and clarify the applicability of those Sections to FSLIC-insured institutions.

Subsection 108(d). Subsection 108(d) amends the Savings and Loan Holding Company Amendments to exempt from prior approval requirements set forth therein the formation of a savings and loan holding company involving a simple reorganization of interests from individual ownership to holding company form. Thus, prior approval by the FSLIC is not required in connection with a reorganization in which a person or group of persons owning a FSLIC-insured thrift transfers shares to a newly formed holding company and receives substantially the same proportional share interest in the holding company that they had in the thrift prior to the holding company formation (except for changes due to the exercise of dissenting shareholder appraisal rights). This is similar, although not identical, to the exemption from the prior approval requirement for a reorganization to form a bank holding company as discussed under Subsection 104(b) of the bill. This section is intended to reduce the time and expense involved in forming a holding company and complements the changes made in the Securities Act of 1933 by Section 102 of this bill.

Under current law, the acquisition of a FSLIC-insured thrift institution is exempt from the FSLIC prior approval requirement if the institution is "acquired in connection with a reorganization in which a person or group of persons, having had control of an insured institution for more than three years, vests control of that institution in a newly formed holding company subject to the control of the same person or group of persons." This language is subject to several interpretations and is complicated because of the ambiguity surrounding the issue of when "control" is present. Therefore, the bill clarifies the meaning of a "reorganization" that is not subject to the prior approval requirement and provides a more objective criterion for determining whether a reorganization qualifies for the exemption. The requirement that the control group have had such control for three years prior to the holding company formation is deleted, since any change in control involving individuals owning a FSLIC-insured thrift is subject to the Change in Savings and Loan Control Act of 1978 (12 U.S.C. 1703(1)(6)).

Subsection 108(e). Subsection 108(e) amends the Savings and Loan Holding Company Amendments to prevent a state from prohibiting the affiliation of any Federally chartered thrift institution with a company engaged in only the activities newly authorized for savings and loan holding companies under this bill. These activities include: insurance underwriting and brokerage; real estate investment, development and brokerage; depository institution securities affiliate activities; activities of a financial nature and those closely related to banking; owning shares in an export trading company or in a bank; and any bank holding company activities not otherwise authorized for savings and loan holding companies.

SECTION 109 - Savings and Loan Service Corporations

Subsection 109(a). Subsection 109(a) amends the Home Owners' Loan Act of 1933 to authorize Federally chartered thrift institutions to invest in "depository institution service corporations" but only in accordance with the requirements, conditions, and limitations in the Depository Institution Service Corporation Act set forth in Section 110 of this bill.

An exception to this limitation on service corporation activities covers federally chartered qualified thrift lenders. Such QTL's would continue to be authorized to invest in service corporations in an amount up to 3 per cent of the thrift's assets (provided that not less than one-half of that investment over one per cent of assets is used primarily for community development purposes). The service corporation must be located in the same state as its parent thrift and its stock must be available for purchase only by thrifts. The Bank Board would continue to regulate the activities of such service corporations.

An independent state chartered association would continue to be covered by the service corporation statutes and rules of its chartering state, as would a state chartered QTL in a unitary S&L holding company structure. Non-QTL state savings institutions (and subsidiaries) that were in holding companies would fall under the multiple S&L holding company activities rules.

Subsection 109(b). Subsection 109(b) amends the provisions of the Home Owners' Loan Act to permit a trade association to commence, on behalf of one of its members, a private right of action for injunctive relief against threatened loss or damage resulting from a violation of that Act's prohibitions against tying arrangements. This parallels a similar provision with respect to banks, which is discussed under Section 107.

SECTION 110 - Depository Institution Service Corporations

Section 110, in effect, repeals the current Bank Service Corporation Act and replaces it with a new act entitled the "Depository Institution Service Corporation Act", ("DISCA"). This act governs investments in newly authorized "depository institution service corporations" ("DISCs") and operations of such corporations with respect to both FDIC-insured banks and FSLIC-insured thrifts, except for Qualified Thrift Lenders. (While not covered under this provision, consideration will be given to including QTL's, since the powers of depository institution service corporations are designed to facilitate and make more efficient internal operations of depository institutions.) Because all DISCs operate under this provision of law, different types of depository institutions in any combination may invest in such corporations.

In general, the new Depository Institution Service Corporation Act combines certain provisions of the Bank Service Corporation Act of 1962, as amended by the Garn-St Germain Act of 1982 ("the 1982 Act"), and the regulations of the FHLBB regarding service corporation activities to achieve a comprehensive law for DISCs.

The definitions in Section 1 of DISCA are taken in large part from the Garn-St Germain Act; however, the definitions of "appropriate Federal supervisory agency" and "depository institution" are expanded in the Act to permit investments by FSLIC-insured thrifts in addition to banks.

Section 2 of DISCA provides limitations on the amount of investment, i.e., 10 percent of paid-in and unimpaired capital and unimpaired surplus and no more than 5 percent of total assets. These limitations are taken from the Bank Service Corporation Act of 1962, as amended by the 1982 Act.

Section 3 of DISCA limits the scope of permissible DISC activities to those contained in the 1962 Act and to certain activities contained in the relevant FHLBB regulations. This Section is intended to limit the activity of DISCs to those primarily of a clerical nature or related to internal operations, in order to assist depository institutions in minimizing the expenses of carrying out their traditional activities. It is not intended to permit DISCs to engage in activities of a retail nature. Thus, the activities that would not be permissible for DISCs include those activities (such as activities closely related to banking) that were added by the 1982 Act, and a variety of business activities permitted for thrift service corporations pursuant to FHLBB regulations. Such prohibited business activities include: making consumer loans; providing tax return preparation services; acquiring, maintaining, managing and developing real estate; and insurance agent or broker services. This Section also deletes the provisions of the 1982 Act authorizing service corporations to provide nondepository institutions with any services that could be provided to depository institutions.

Section 4 of DISCA prohibits depository institution service corporations from unreasonably discriminating in the provisions of services to any non-stockholder depository institution in competition with a stockholder of such depository institution. This provision, derived from the 1962 Act, reflects certain changes made by the 1982 Act.

Section 5 of DISCA is essentially the same as that of the 1982 Act except for certain technical changes made in light of the expansion of investor authority to include thrifts.

Section 6 of DISCA provides grandfather rights to service corporation investors and for service corporation activities where an investment was made and the activities were commenced prior to July 1, 1983, in accordance with then existing laws.

In addition to maintaining current activities and investments, an affected service corporation -- i.e. a bank service corporation or a non-QTL federal association's service corporation -- could expand only those activities that it was engaged in on July 1, 1983, and a depository institution investor could expand its investment provided that such expansion conformed with all laws, rules or regulations applicable to service corporations and investments therein that were in effect on July 1, 1983. Consequently, the activities of service corporations would be grandfathered, and investors' grandfather privileges would permit them to invest in service corporations pursuant to the more permissive laws and regulations in effect on July 1, 1983, without regard to the new Service Corporation Act provided by this bill.

The grandfathering authority provided in Section 6 of DISCA would terminate with respect to a service corporation at the time it expands into any new activities that were not engaged in on July 1, 1983, or, with respect to an investor depository institution, at the time it invests in a service corporation in a manner not consistent with the laws and regulations applicable to service corporations as of July 1, 1983.

To eliminate the potential for severe financial problems or other adverse impact on the public interest resulting from required divestiture or termination of activities, the appropriate Federal agency may, upon application, authorize the continuation of such service corporation activities or retention of share interest for up to one year. With respect to any application described in the preceding sentence, it is not intended that a loss of potential profit would be sufficient reason for granting such an extension.

Because many thrift institutions are in mutual form, they are unable to expand their nondepository activities through a holding company, as provided in this bill for stock institutions. Accordingly, it seems appropriate to permit thrift institutions in mutual form to continue to make use of the limited service corporation authority available to them on July 1, 1983. Therefore, the seventh provision of Section 25 authorizes a mutual thrift to invest up to three per cent of its assets in intrastate thrift service corporations subject only to laws and regulations applicable to such service corporations on July 1, 1983. (This authority is concurrent with and not in addition to the three per cent investment power under section 109 of this bill.) Unlike the other grandfathering provisions of this Act, this provision does not merely provide for the maintenance of the status quo; it authorizes all mutual thrifts, whether or not in existence on July 1, 1983, to invest, within the specified limitations, in any thrift service corporation that may engage in all thrift service corporation activities authorized as of July 1, 1983, whether or not it engaged in such activities on July 1, 1983. The operation of and investment in such a mutual thrift service corporation would be subject to FHLBB regulations, including Section 545.9 of Title 12 of the Code of Federal Regulations. Thus, for example, the activities of such a mutual thrift service corporation would not be limited to those specified in Section 3 of DISCA, but would include all of those permissible under FHLBB regulations in effect on July 1, 1983.

Title II - Credit Unions

Several revisions are made to federal statutes affecting credit unions in order to make technical corrections and to provide credit unions with greater capital gathering and investment opportunities. The following are the specific areas affected:

1. Second mortgage loans (Section 201) - Provides the NCUA Board with authority to allow second mortgages to be written by federal credit unions for periods exceeding 15 years.

2. Membership shares (Section 202) - As a way for credit unions to raise capital, authorizes federal credit unions to establish membership share certificates which would be non-deposit accounts maintained by their members.

3. Faithful Performance (Section 203) - Revises the traditional fidelity bond coverage standard to ensure that it is comparable to other financial institutions.

4. Change in Insurance Status (Section 207) - Permits a federally insured credit union to convert to state insured status upon the affirmative vote of a majority of credit union members who vote on the proposition. Currently, the standard requires a majority of those voting in a vote in which at least 20 percent of the total membership votes. The "majority of those voting" standard is used in federal to state charter changes and would therefore make insurance conversions subject to a similar requirement.

Title III - Bankers Banks

This clarifies that bankers banks may invest in export trading companies, provide services to bank holding companies, and makes technical changes to the bankers bank statutory provisions.

Title IV - Interest on Reserves

This title, separately introduced as S.1750, directs the Federal Reserve Board to pay interest monthly on reserves held against money market deposit accounts, super NOW accounts, and any new transaction accounts authorized by DIDC after December 1, 1982, at the rate earned on the Federal Reserve's securities portfolio that month. Interest will be pro-rated to the institutions holding reserves.

Title V - Consumer Leasing

This title amends the consumer leasing provisions of Title I of the Consumer Credit Protection Act (CCPA) and creates a separate Title X of that Act for all of the provisions relating to leasing. New provisions covering rental purchase agreements are also added to Title X of CCPA.

The title is divided into four parts. The first part contains general provisions, such as definitions and rule-writing authority. The second part contains the major substantive provisions which set forth the disclosure and advertising rules for consumer leases and rental purchase agreements, and the limitations on liability at the end of a consumer lease. The third part contains all of the provisions relating to enforcement and liability. The fourth part contains other miscellaneous provisions, including the preemption and exemption standards.

This title closely follows S.1152, introduced earlier in the session, but differs from the bill in the following ways:

1. The definition of a consumer lease was expanded to include the purchase of services incidental to the lease.

2. The definition of a rental purchase agreement was amended to cover purchase options. A requirement for disclosure of the number, amounts and timing of all payments necessary to acquire ownership of the property was added, as was a requirement for a statement in advertisements that the consumer has no ownership rights if the total amount is not paid.

3. Personal property leases which are incidental to real property loans were exempted from the act.

4. The substitution of the leased property, in a multiple item lease, does not constitute a renegotiation of the lease.

5. The Federal Reserve Board is authorized to prescribe by regulation other events which do not constitute an extension

Title VI - Check Holding Disclosure

This title, separately introduced as S.573, would:

(a) require banks to disclose their hold policies to customers,

(b) require a drawing bank to notify the paying bank within 24 hours of the time that the drawing bank determines that a check of $250 or more is not payable, and

(c) require depository institutions to begin computing interest on deposits to interest bearing accounts no later than the date on which the institution receives provisional credit.

Title VII - Usury Preemption

This title, separately introduced as S.730, preempts state interest rate ceilings on business, agricultural and consumer credit. States are given a 3 year period in which they may reject the Federal preemption and impose rate restrictions of any amount and in any form. Moreover, this title would preserve the actions of those states that had overridden the Federal preemption of business and agricultural interest rate ceilings in the Depository Institutions Deregulation and Monetary Control Act of 1980.

Title VIII - Interest on Checking

This title, introduced separately as S.1875, repeals the prohibitions in the Federal Reserve Act, the Federal Deposit Insurance Act, and the Home Owners Loan Act against payment of interest on demand deposits by insured banks and federal savings institutions.

This title amends provisions governing reserve requirements presently being phased-in for non-Federal Reserve member institutions, to prevent institutions from diverting customers from NOW accounts, which require full reserves, to checking accounts, which require only partial "phase-in" reserves. Institutions would be required to hold full reserves for increases in checking deposits that occur after the title's enactment. DIDC is to set rules for interest on checking with the same interest rate limitations as presently exist for NOW accounts. This title is not effective until 180 days after enactment to allow institutions time to prepare for interest on checking.

This title also adds non-profit political committees and groups to the list of organizations eligible for NOW accounts.

Title IX - Credit Card Fraud

This title, separately introduced as S.1555:

Redefines the term "credit card" in criminal provisions of the Truth in Lending Act to include an actual or fictitious account number or other access to an account number, in order to close a loophole created by court decisions ruling that fraudulent misuse of credit card account numbers does not constitute fraudulent misuse of a "credit card".

Amends the Truth in Lending Act and Electronic Funds Transfer Act to bar any scheme to defraud with the use of a credit or debit card.

Makes it a crime to sell, or use an account, or to access an account number, with an unlawful intent.

Makes it a crime to possess with an unlawful intent five or more counterfeit or fraudulently obtained credit or debit cards, in order to facilitate prosecution of credit or debit card fraud cases involving organized criminal activities.

S.1555 has been modified in this title to add a new provision extending the bill's prohibitions to the possession of counterfeit or fraudulently obtained credit or debit cards.

Title X - Regional Interstate Banking Compacts

This title of the bill authorizes states to establish interstate banking and branching standards subject to regional or other geographical limitations or based on reciprocal laws of other states. This is designed to recognize regional and reciprocal arrangements and to provide more certainty with regard to state statutes establishing such arrangements.

The CHAIRMAN. Today we have two distinguished panels. The first is composed of Mr. David F. Woods, CLU, Springfield, Maine, National Association of Life Underwriters; Ken Osborne, member, Federal affairs committee, Independent Insurance Agents of America; president, Superior Insurance Service, Salt Lake City, Utah; Harold F. Custis, CLU, member, legislative committee; chairman, professional liability subcommittee, National Association of Casualty and Surety Agents; president, Corporate Insurance Management Inc., Washington, D.C.; J. Knox Hillman, Jr., chairman, Government affairs committee, Professional Insurance Agents; Shuford Insurance Agency, Concord, N.C.; Richard A. Nielsen, on behalf of the National Association of Insurance Brokers; president, Johnson & Higgins of Delaware, Wilmington, Del.; Director, Johnson & Higgins, New York, N.Y.

Senator Proxmire, do you have any comments you wish to make?

Senator PROXMIRE. No, Mr. Chairman.

The CHAIRMAN. I understand Mr. Woods will give the opening statement.

STATEMENT OF DAVID F. WOODS, CLU, SPRINGFIELD, MASS.; TRUSTEE, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, ACCOMPANIED BY THOMAS WILSON, COUNSEL

Mr. WOODS. Thank you, Mr. Chairman. My name is David Woods. I am a life insurance agent with the Massachusetts Mutual Life Insurance Co. in Springfield, Mass., and a trustee of the National Association of Life Underwriters. I am speaking today on behalf of an insurance producer group coalition which includes the National Association of Life Underwriters, the Independent Insurance Agents of America, represented on my left by Mr. Ken Osborne; the Professional Insurance Agents represented by Mr. Knox Hillman; the National Association of Casualty and Surety Agents, represented by Mr. Harold Custis; the National Association of Surety Bond Producers, and the National Association of Insurance Brokers, represented by Mr. Richard Nielsen.

Together, these associations represent most of the life, property/casualty, personal and commercial lines agents and brokers in the country.

Additionally, I would like to introduce Mr. Tom Wilson on my right, who is counsel to the coalition.

[Complete statement follows:]

Oral Remarks By
Mr. David F. Woods, CLU, ChFC
Trustee
Of
The National Association of Life Underwriters

On Behalf of
The Independent Insurance Agents of America
The Professional Insurance Agents
The National Association of Casualty and Surety Agents
The National Association of Surety Bond Producers
The National Association of Insurance Brokers

Delivered to
The Committee on Banking, Housing and Urban Affairs
of
The United States Senate

March 6, 1984

Mr. Chairman, my name is David F. Woods. I am a life insurance agent with the Massachusetts Mutual Life Insurance Company in Springfield, Massachusetts, and a Trustee of The National Association of Life Underwriters. I am speaking today on behalf of a coalition of insurance producer groups - a coalition which includes The National Association of Life Underwriters, the Independent Insurance Agents of America, the Professional Insurance Agents, the National Association of Casualty and Surety Agents, the National Association of Surety Bond Producers, and the National Association of Insurance Brokers. Together these Associations represent most of the life, property/casualty, personal and commercial lines agents and brokers in the country.

We would first like to offer some brief general observations on financial institutions reform, and then specific comments on legislation now before your Committee. Each of our Associations will submit supplementary material to the Committee, and we ask that it be made part of the record.

To begin, we offer the following general observations:

First Congress should decide: We agree emphatically with statements recently made by the Chairman and other members of this Committee that the ground rules for financial institutions reform should be set by Congress. In the context of banking, it is not enough to look approvingly on the innovations of the marketplace or the legal ingenuity of our nation's largest banks. Congress must determine whether certain changes are in the public's interest, and, if they are not, then it is Congress that must set limits that are relevant to the day-to-day conduct of banking. If comprehensive reform proves unattainable this year, Congressional prerogative to redesign the banking system must be preserved by enacting whatever temporary or limited permanent legislation may be necessary to prevent the continued erosion of existing boundaries and to retain Congress' ability to examine bank reform at a future time.

Our second general observation is that the Missing Ingredient in the Whole Equation is The General Public: It is lamentable that the present debate on reform of financial institutions is perceived as a clash between powerful special interests. We emphasize to the Committee that the importance of these issues goes beyond the marketing strategies and profit margins now being discussed in the board rooms of Citicorp and Prudential/Bache. As you know, Mr. Chairman, insurance agents occupy a unique vantage point to gauge consumer demands. The nature of our work requires that we contact thousands of individuals and families over the course of a year. The membership of the organizations represented here today talks to tens of millions of consumers each year. Although we cannot produce an NBC News/Washington Post poll as documentation, we know our clients, both personal and commercial, value highly the benefits provided by today's fiercely competitive insurance marketplace. Many have expressed their concerns that broader bank authority to connect insurance sales to lines of credit will mean a loss of both bargaining position and the freedom to shop in conventional markets.

Which raises the related question, of course, whether the current clamor for expanded bank powers is, in fact, consumer driven as the banks assert, or whether it reflects instead a cool assessment of the bank bottom line. It is crucial that this Committee get a totally clear picture of what these issues and proposals mean to the ordinary citizens beyond the Potomac River.

Observation three, Credit Tie-ins are Fact Not Fiction: Banks suffer from one great disadvantage in arguing the credit tie-in issue, Mr. Chairman - their record. That record is long, fully documented, and most recently highlighted by members of this coalition in comments to the Federal Reserve Board on proposed revisions to the credit life insurance provisions of Regulation Y. We have attached to this statement a complete text of that filing. No matter how you look at it, the banks' record on credit tie-ins paints a clear and unappealing picture of abuse; higher premiums, exorbitant profits, reverse competition for higher commissions, massive market penetration rates, unnaturally low loss ratios, and inadequate disclosure to consumers of double coverages, policy expirations, and claims collections. Distinguished members of the Committee - don't take our word for it; read the record, and then reassess the banks' claims of benefits to the public in the context of their unrestrained use of credit leverage in insurance sales.

Fourth - the Banking Industry is in a Critical Condition: It seems to us incongruous that banks should now come to Congress for insurance, securities and real estate underwriting and sales authority at just the time the banking industry manifests its greatest lack of stability in recent memory. Only a few months ago, bank failures were on the front pages, and Congress had to wrestle with the financial and regulatory implications of the foreign loan transactions of our nation's largest, most sophisticated banks. The particular circumstances of bank failures vary, but is is our contention that they are directly relevant to the question of deregulation and expanded powers. Before considering product deregulation, we believe it is worth exploring whether or not our banks can perform the services and fulfill the responsibilities with which they are entrusted under current law.

In like manner inquiry should be made into how persistently the troubles of one part of the system come to affect the viability of other parts - even those parts that may not be formally affiliated. A certain prescription for disaster is to superimpose upon an already shaky base riskier authority, under less stringent regulatory oversight. In this context we note particularly the recent lament by the FDIC of its inability to cope in an effective manner with the burgeoning and ultimately fatal problems leading to the collapse of the Butcher Banking empire.

So much for general observations. We now point to those sections in the bills before your Committee that give us particular cause for alarm. We refer to those sections which (1) provide explicit authority for bank holding company insurance sales and underwriting; (2) eliminate the application and hearing procedures and the public benefits test now required for BHC entry into new business; (3) offer a right of action in the courts and several coercion of debtor provisions as remedies to anti-competitive credit tie-ins; and (4) ineffectively address the opportunities for circumventing Federal law presented by enactment of State laws like the one in South Dakota.

Let's take these one at a time.

First - Providing unlimited authority for bank holding company insurance sales and underwriting would abrogate Congress' decision of less than two years ago explicitly to prohibit most bank holding company insurance activities. Congress was persuaded to establish this statutory restriction for both historical and practical reasons. From the historic perspective, Congress reaffirmed the separation between banking and commerce that for fifty years has proscribed the authority of most banking institutions to engage in insurance activities. From a practical standpoint, Congress in 1982 recognized the anti-competitive effects implicit in banks' control of credit. We are aware of no changes - either an increase in Congressional sentiment, or a decrease in the dangers of credit tie-ins to the public and to unaffiliated small businesspeople, that would warrant such a dramatic departure from existing public policy.

Our second specific concern involves the proposed removal of application and hearing procedures and the public benefits test now contained in Section 4(c)(8). We fear such removal would leave interested parties virtually no opportunity to object to or to request an impartial examination of activities the Federal

Reserve Board may deem to be pro-competitive. The four broad criteria which would serve as the Board's new standard for approving activities provide no basis for assessing the long-term public interest implications of these activities. This fact, combined with the Board's authority to add, almost at will, to the list of activities determined to be "of a financial nature", would mean that the ultimate scope of bank holding company activities would be completely unpredictable. Such unpredictability obviously contains the potential for great public harm. In the name of administrative convenience, the bills under consideration would enable bank holding companies to escape public scrutiny.

Our third concern focuses on the proposed provision for a private right of action for trade associations on behalf of members who claim to have been harmed by credit tie-ins. This is a totally inadequate and undesirable remedy for the major problem associated with bank holding company insurance activities. The proposed remedy of injunctive relief is prospective only and therefore provides no relief for consumers who may already be victims of credit tying. Moreover, the evidence necessary to prove anti-competitive tying is notoriously intangible and often difficult or impossible to elicit from aggrieved parties - facts that make tying as prevalent and harmful as numerous studies have shown. Finally, the costs in time and money associated with lawsuits, plus the added burden on an already overused court system, make this approach unappealing.

The Financial Services Competitive Equity Act adds to the right of action in the courts a list of anti-tying provisions.

Most of these provisions have already been applied, largely unsuccessfully, for a number of years in several states where they are known as coercion of debtor provisions. In connection with credit tying, coercion of debtor provisions may actually ratify and make it easier to conceal the anti-competitive tie-in. Because the tie-in is intrinsic to a lender's authority to offer the insurance product, the ability to follow a series of required disclosures simply bestows on the practice a misleading legal seal of approval. Even though tying may have occurred - and may have been instigated by the ability to produce documents which purport to show it had not - coercion of debtor provisions remove any basis for establishing anti-competitive behavior. In his testimony last week before this Committee, and just last month in testimony to a New York State Commission on Financial Institutions, the vice president of the National Association of Insurance Commissioners, Bruce Foudree, reported that in his State of Iowa, considered to have one of the strongest coercion of debtor laws on the books, these provisions have not worked and may even have enhanced the opportunities for credit tying.

Finally, we point out that there are two parts to the so-called South Dakota problem. Unfortunately the comprehensive reform bills before your Committee address only one of them. One part of the problem is the ability of an individual state, South Dakota for example, to rewrite the rule book for everybody else. This is the issue the proposed bills attempt to address. In the South Dakota law a state bank or a bank holding company which owns a state bank may engage in insurance and other activities anywhere except in South Dakota. But that is a peculiarity of that law -

one that could be remedied very easily to comply with the requirements of the state law provisions offered in pending legislation. (In fact, it may already comply, as South Dakota's attorney general recently offered the opinion that the language intended to limit in-state activities could not actually preclude them.)

But left unaddressed by the bills before this Committee is the second, more important part of the South Dakota problem - namely a state's ability to invest federal bank holding companies with broader authority than that granted to them under Federal law. States do not have this authority now, since Congress, in the Bank Holding Company Act, left to the states only the authority (1) to decide whether BHCs may operate within their borders, and (2) to limit BHC activities to those permitted under Federal law, or set their own more restrictive standards.

Thus, a state bank subsidiary of a bank holding company cannot in any context - in or out of state - provide an opportunity for bank holding companies to circumvent Federal law. This is particularly true with respect to insurance. Congress made explicit and clear in the Garn-St. Germain Act its desire to limit bank holding company insurance activities.

We remind the Committee, the Federal Reserve Board reaffirmed in January the preeminence for federal BHCs of the insurance limits contained in the Bank Holding Company Act. You may recall this was in connection with several applications by BHCs to engage through state banks under State law in broader insurance activities than the Federal Act permits. The Federal Reserve Board stated that the proposed bank acquisitions could not be approved under present law. In reaching this conclusion, the Board referred specifically to Title VI of Pub. Law 97-320. The language in S.2181 and S.2134 changes the current configuration of the law, and would permit that which is not now permitted: namely activities through a banking subsidiary of a BHC which are otherwise prohibited to BHCs under Federal law.

Mr. Chairman, my colleagues and I urge this Committee to look hard at what the banks seek and why they seek it. Wholesale entry by banks into the insurance business will create no new capital source, no new jobs, no new products, and no new services. Bankers themselves don't pretend to be better salespeople, or to have better insurance products or service - or to offer better prices or to be more available. Many of them don't even pretend to know anything about insurance. What they do know is that they can get the insurance business because of the leverage of the credit relationship. If they succeed on this basis, neither the public nor the insurance industry will be well served.

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BEFORE THE
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
Washington, D.C. 20551

In the Matter of the)

BOARD OF GOVERNORS OF THE)
FEDERAL RESERVE SYSTEM'S)
) Docket No. R-0491
Proposed Elimination of the Rate)
Reduction Requirement From Its)
Credit Life and Credit Accident)
and Health Insurance Underwriting)
Regulation)

Comments of the

NATIONAL ASSOCIATION OF INSURANCE BROKERS
NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS
PROFESSIONAL INSURANCE AGENTS
and
THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

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January 24, 1985

I. INTRODUCTION

The Board of Governors of the Federal Reserve System ("Board" or "Federal Reserve Board") has declared the underwriting of credit life and credit disability insurance to be a permissible activity for bank holding companies. The regulation wherein the Board has made that declaration is 12 C.F.R. § 225.4(a)(10)(1983). The Board proposes materially to revise that regulation by eliminating from it footnote 10a, which requires an applicant seeking approval of an application for authority to act as a credit insurance underwriter to provide rate reductions or increased policy benefits. 1/ Before promulgating the revised regulation in final form, the Board has invited interested parties to express their views on the proposed

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1/ 49 Fed. Reg. 53,125 (1984).

elimination of footnote 10a. These comments are submitted on behalf of the National Association of Insurance Brokers ("NAIB"), National Association of Casualty and Surety Agents ("NACSA"), Professional Insurance Agents ("PIA"), and the National Association of Life Underwriters ("NALU") (hereinafter referred to together as the "insurance producers").

NAIB is an association that represents major commercial insurance brokers who sell and service business related insurance products throughout the United States and around the world. NACSA is an association representing 252 of the nation's leading commercial insurance and brokerage firms. PIA is a national trade association representing more than 40,000 independent property and casualty insurance agents in all 50 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands. NALU is a national trade association that represents more than 1,000 state and local life underwriter associations, which, in turn, represent over 125,000 life and health insurance agents, and general agents and managers throughout the country. Together, the insurance producers comprise most of the distribution network of the insurance industry in the United States.

These comments will (i) summarize the statutory framework of the credit insurance regulation; (ii) describe credit life and credit disability insurance and the history of credit insurance sales by banks, bank holding companies and other lenders; (iii) detail the abuses that have occurred over the years in connection with sales of credit insurance by banks, bank holding companies and other lenders; and (iv) recommend changes in the Board's credit life underwriting regulation other than the change proposed by the Board, in order to bring the Board's credit insurance underwriting regulation into full conformity with the public benefits requirements of the Bank Holding Company Act of 1956. For reasons to be enumerated, any decisions by the Board to eliminate the premium concessions and policy benefit requirements of its current credit insurance regulation would be seriously detrimental to the public interest and would constitute action that would be arbitrary, capricious, an abuse of the Board's discretion and contrary to law.

II. DISCUSSION

A. Statutory Framework of the Board's Credit Life Regulation

The activities of bank holding companies are regulated by the Bank Holding Company Act of 1956 ("BHC Act"). 2/ Section 2(a)(1) of the BHC Act defines a bank holding company as a company that controls one or more banks. 3/ Section 4 of the BHC Act prohibits bank holding companies from owning the shares of any company that engages in any activities other than banking or managing or controlling banks. 4/

The BHC Act contains a number of exceptions to the general nonbanking prohibition. The principal exception is contained in Section 4(c)(8) of the BHC Act, which authorizes bank holding companies to own the "shares of any company the activities of which the Board

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2/ 12 U.S.C. §§ 1841-50 (1982).

3/ *Id*. at § 1841(a)(1).

4/ *Id*. at §§ 1843 (a)(1) and (a)(2).

. . . has determined . . . to be so closely related to banking . . . as to be a proper incident thereto." 5/ Section 4(c)(8) goes on to state that, in determining whether a particular activity qualifies as a "proper incident" to banking, the Board must evaluate whether the performance of the activity by a bank holding company

> can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices. 6/

Section 4(c)(8) is broadly accepted as prescribing a two tier test -- the first tier involves a Board determination that the activity in question is generically "closely related" to banking; the second requires a Board determination that approval of a bank holding company application to engage in a "closely related" activity in a particular way can reasonably be expected to result in benefits for the public that outweigh the possible adverse effects. 7/

In 1971, the Board conducted a rulemaking proceeding to determine what insurance activities qualified as "closely related" to banking. In August 1971, that proceeding culminated in the Board's determination that certain insurance agency activities were "closely

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5/ Id. at § 1843(c)(8).

6/ Id.

7/ See, e.g., Independent Insurance Agents of America, Inc. v. Board of Governors of the Federal Reserve System, 658 F.2d 571, 573 (8th Cir.), reh'g denied, 664 F.2d 177 (1981); Connecticut Bankers Ass'n v. Board of Governors of the Federal Reserve System, 627 F.2d 245, 249 (D.C. Cir. 1980); Nat'l Courier Ass'n v. Board of Governors of the Federal Reserve System, 516 F.2d 1229, 1232-34 (D.C. Cir. 1975).

related" to banking. 8/ At the same time, the Board announced that it would defer to a later time the possible promulgation of regulations relating to insurance underwriting activities. 9/ In 1972, the Board promulgated a second insurance regulation which authorized bank holding companies to act as underwriters of credit life and credit accident and health insurance. 10/

The Board has acknowledged that it was aware that pursuit of credit insurance activities by bank holding companies could result in certain adverse effects on the public. 11/ Being mindful of Section 4(c)(8) "public benefit" requirement, the Board stated that it would "only approve applications [to underwrite credit life and credit disability insurance] in which an applicant demonstrates that approval will benefit the consumer or result in other public benefits." 12/ Accordingly, in promulgating its credit insurance underwriting regulation, the Board included within that regulation a footnote reading as follows:

8/ 36 Fed. Reg. 15,525 (1971) (codified as amended at 12 C.F.R. § 225.4 (a)(9) (1983)). On October 15, 1982, Congress enacted Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982) as amended by S.J. Res. 271, Pub. L. No. 97-457, 96 Stat. 2508 (1983). Section 601 of Garn-St Germain amended Section 4(c)(8) expressly to prohibit bank holding companies from participating in most insurance activities. Subsection (A) of Section 601, however, exempted from the prohibition the bank holding company credit insurance underwriting activities authorized under 12 C.F.R. § 225.4(a)(10) of the Board's Regulation Y. See 12 U.S.C. § 1843(c)(8)(A) (1982).

9/ See, e.g., 37 Fed. Reg. 28,046 (1972).

10/ Id. (codified as 12 C.F.R. § 225.4(a)(10) (1983)).

11/ See 48 Fed. Reg. 53,125, 53,126 (1983).

12/ Id.

> To assure that engaging in the underwriting of credit life and credit accident and health insurance can reasonably be expected to be in the public interest, the Board will only approve applications in which an applicant demonstrates that approval will benefit the consumer or result in other public benefits. Normally, such a showing will be made by projected reduction in rate or increase in policy benefits due to bank holding company performance of this service. 13/

In 1976, the Board extended the requirements embodied in the foregoing footnote. Specifically, the Board adopted an interpretation of its credit insurance rule that obligated bank holding company credit insurance underwriters to provide premium concessions on a *ongoing* basis. 14/ The Board decreed as follows:

> In order to avoid [the nullification of public benefits resulting from premium concessions subscribed to by the applicant in its initial application], the Board has interpreted section 4(c)(8) of the [BHC] Act and § 225.4(a)(10) of Regulation Y and its accompanying footnote as imposing a continuing obligation upon all bank holding companies authorized to underwrite such credit insurance pursuant to section 4(c)(8) of the [BHC] Act and the Board's Regulation Y, to maintain a public benefit such as was anticipated and considered by the Board at the time of the original approval of each application, and was envisioned by the Board when this activity was adopted as a permissible nonbanking activity under section 4(c)(8) of the [BHC] Act. 15/

To implement the premium concession and policy benefit requirements of the credit insurance regulation, the Board staff has published schedules of rate reductions required in specific states in order

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13/ 12 C.F.R. § 225.4(a)(10) n.10a (1983).

14/ 41 Fed. Reg. 22,260 (1976) (codified as 12 C.F.R. § 225.135 (1983)).

15/ *Id*. at § 225.135(d) (footnote omitted).

to obtain Board approval of credit insurance underwriting applications. 16/ Typically, the schedule maintained by the Board staff at its various Reserve Banks express rate reductions in terms of some percentage from the credit insurance state prima facie rate, the highest rate at which particular coverages may lawfully be sold in specific states.

In 1983, the Board solicited public comments on a series of new regulations that were designed comprehensively to revise the Board's Regulation Y. 17/ Some comments received in the context of Regulation Y apparently urged the Board to eliminate footnote 10a of its credit insurance regulation. 18/ According to the Board, those commentors alleged that the premium concession and policy benefit requirements of the Board's regulation "place[] bank holding company providers of [credit insurance] service[s] at a competitive disadvantage to other participants in the market and that no significant evidence of the potential adverse effects considered by the Board eleven years ago has come to light." 19/

The remainder of these comments will evaluate the foregoing allegations.

16/ 48 Fed. Reg. 53,125, 53,126 (1983).

17/ 48 Fed. Reg. 23,520 (1983).

18/ 48 Fed. Reg. 53,125, 53,126 (1983).

19/ *Id.*

B. Description of Credit Life and Credit Disability Insurance and the Abuses Associated With Credit Insurance Sales

1. Credit Insurance

Credit life and credit accident and health insurance are specialized forms of insurance designed to repay the lender the outstanding balance on a borrower's loan in the event of the death or disability of the borrower. 20/ Credit insurance is typically sold in connection with consumer loans made by banks, finance companies, automobile dealers and retail outlets.

Credit life insurance is almost always sold to lenders as a group policy. Borrowers from time to time are added to the policy as additional named insureds. The incremental increase in cost of the insurance is passed along to borrowers and is usually folded into the credit transaction. In this way, the cost of the insurance is borne by the consumer and disappears into the loan transaction. The lender -- not the borrower -- is the beneficiary on credit insurance policies.

Credit insurance is sold by lenders as an integral part of loan transactions. In the case of banks, credit insurance is sold by loan officers. The marginal increase in the overhead of a bank in connection with credit insurance sales is minimal. Special licenses are typically required from the states for authority to sell credit insurance coverages, but the technical knowledge required by loan

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20/ See Hubbard, Consumer Credit Life and Disability Insurance, at 9-18 (Ohio University 1973).

officers in order to sell the product is inconsequential. Sellers of credit insurance products do not need to make any underwriting judgments -- the terms of the policies are broad and clear. The borrower either wishes to take out the coverage or he does not. If he does, the loan officer checks a box on the loan application form and the cost of the insurance is added on to the principal amount of the borrower's loan.

Most credit life underwriters impose some limitations on their credit life policies. Those limitations are usually minimal -- the insured must be under 65, death may not occur as result of suicide, and, occassionally, the debtor may not be terminally ill when the policy is written. 21/ Limitations imposed on credit disability policies are somewhat more complex, but also minimal. 22/

Credit life insurance first began to be sold in 1917. 23/ Since that time, credit insurance has grown into a major industry. In 1925, there was $18 million of credit life in force. By 1981 -- the last year for which figures are currently available -- credit life insurance in force had grown to $162.4 billion. 24/

21/ Hubbard, *supra*, at 16.

22/ *Id.* at 17.

23/ *Id.*; *1982 Life Insurance Fact Book*, at 32 (ACLI 1983).

24/ *1982 Life Insurance Fact Book*, *supra*, at 32.

2. Credit Insurance Abuses

a. General Nature of Abuses

The sale of credit insurance is a national scandal. Partly because insurance is by its nature abstruse, partly because credit insurance is sold in conjunction with credit transactions, and partly because the cost of credit insurance (while itself vastly overpriced) is small in comparison with the credit transaction of which it is made a part, the public has been able to be subjected to a whole raft of serious abuses in connection with its sale. Rapacious overcharging, failure to return unearned premiums when loans are paid off or the borrower dies during the term of the loan, failure to notify survivors of borrowers that loans have been paid off by credit insurance, and tying sales of credit insurance to extensions of credit have all been common practices in connection with credit insurance sales. 25/

A massive record of credit insurance abuses has been accumulated at both federal and state levels. Since 1955, Congress itself has

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25/ See, e.g., Direct Testimony of Robert Sable, Applications of Commerce Bancshares, Inc. and Mercantile Bancorporation, Inc., at 3-15 (Federal Reserve Board, June, 1982) (Missouri R. 3096, 3099-3111).

These comments will refer extensively to evidence that was introduced by the Independent Insurance Agents of America, Inc. and the Independent Insurance Agents of Missouri in connection with Commerce and Mercantile cases. Those cases will be referred to as the "Missouri cases." The evidence in question is of unusually high quality -- it was provided by nationally recognized credit insurance experts; is was detailed, explicit and heavily documented; it is current; and, most importantly, it was sworn to and the witnesses were subjected to cross-examination by hostile bank holding company and Board counsel.

held at least five sets of hearings on the problem. 26/ It is well-documented that bank holding companies and their affiliates have been guilty of most credit insurance indiscretions, especially overcharges and tie-in sales.

b. Credit Insurance Overcharges

Credit insurance protects lenders from losses if borrowers die or are disabled and borrowers or their estates cannot repay whatever portions of loans may remain outstanding. Credit insurance products are indistinguishable from underwriter to underwriter. Because the insurance is sold only in conjunction with credit transactions, and because the cost of the insurance is borne by the borrower (as opposed to being absorbed by the lender as part of its overhead), credit insurance companies have vied with one another to increase the premiums on the insurance in order to be able to pay lenders the highest possible commissions for selling their products, as opposed to the identical products of a competitor.

Before state insurance regulators stepped in to establish rate and commission ceilings, it was common for underwriters to be charging

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26/ Tie-in Sales of Credit Insurance in Connection with Small Loans and Other Transactions, Subcommittee on Antitrust and Monopoly Legislation of the Senate Committee on the Judiciary, 83rd Cong., 2d Sess. (1955); The Consumer Credit Industry (Credit Insurance), Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary, 90th Cong. 1st Sess. (1967); Subcommittee on Financial Institutions of the Senate Committee on Banking and Currency, Hearings on S. 1754 (Consumer Credit Insurance Act), 91st Cong., 1st Sess. (1969); Hearings on Credit Life Insurance, Subcommittee on Antitrust, Monopoly and Business Rights of the Senate Committee on the Judiciary, 96th Cong. 1st Sess. (1979) ("1979 Judiciary Hearings"); Hearings on the Federal Reserve Board's Tie-in Study, Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess. (1979) ("1979 Banking Hearings").

$1.25/$100 of coverage and to be paying commissions of 70 to 80 percent for the doing of what was a wholly ministerial act (check the box). 27/ Thus, because of the distribution scheme, competition among credit insurance underwriters has worked to elevate the cost of that insurance, not to reduce it. This phenomenon has come to be known as "reverse competition" and has resulted in premium overcharges to American consumers that, during just the last decade, may have exceeded $5 billion.

Even studies performed at the behest of the credit insurance industry -- studies that could be expected to portray credit insurance in the most favorable possible light -- concede that aggressive overcharging dominates the industry. For example, in 1957, in a study performed on behalf of the Consumer Credit Insurance Associates, the author concluded:

> [P]resent day commissions on ordinary credit life insurance appear to be excessive . . . .
>
> If commissions for ordinary consumer credit life insurance are excessive, the rate, of which commissions are a major component, must also be high. Because high commissions contribute to a high expense rating, the amount of premium dollar left for payments of losses must necessarily be low. Such appears to be the case in at least a significant portion of the ordinary consumer credit life insurance business . . . . to date no valid argument has been advanced that would justify the present level of commissions being paid to lenders. 28/

27/ Direct Testimony of C. Donald Ainsworth (Missouri Commissioner of Insurance), Missouri cases, at 6 (Missouri R. 2817-28). Commissions on sales of ordinary life insurance and property and casualty insuirance typically range between 12 and 20 percent.

28/ Kedzie, Consumer Credit Insurance (1957), at 162-63.

The 1967 and 1969 hearings held by the Senate Judiciary Committee confirmed the existence of rampant overcharging in the industry. 29/ After the 1969 hearings, Senator Proxmire estimated that American consumers were being overcharged by $250 million annually. A state official -- himself an actuary -- testified at the 1979 Judiciary hearings that annual overcharges may be more than $1 billion. 30/ The most recent study, which was performed by Ohio University at the request of the credit and the credit insurance industries, confirmed Senator Proxmire's $250 million overcharge estimate and concluded that "overcharging is a definite problem within the credit insurance industry." 31/

The phenomenon of "reverse competition" that has characterized the credit insurance industry and the aggressive overcharging to which it inexorably lead prompted the National Association of Insurance Commissioners ("NAIC") to begin investigating the credit insurance industry in the late 1950s. 32/ The inquiries conducted by the NAIC persuaded the insurance regulators to adopt language for model legislation that could be urged upon state legislatures in an effort to restrain the abuses with which the industry was afflicted. 33/ Eventually, the work of the NAIC culminated in the adoption in 1970 of the NAIC's "Richmond Resolution," a resolution that urged

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29/ See note 26, supra.

30/ 1979 Judiciary Hearings, at 7.

31/ Hubbard, supra, at 252.

32/ Direct Testimony of C. Donald Ainsworth, supra, at 6-8 (Missouri R. 2822-24).

33/ See Hubbard, supra, at 38-39.

all insurance regulators throughout the nation to adopt procedures which would limit credit insurance rates to levels that would produce loss ratios (losses as a perentage of earned premiums) of at least 50 percent. 34/

Reacting to the Richmond Resolution, most states began imposing rate and commission ceilings on credit insurance in order to try to achieve loss ratios that at least moved in the direction of 50 percent loss ratio recommended by the NAIC. The efforts were resisted at every turn. The experience of the Missouri Insurance Division in that regard was documented in the Missouri cases and is fairly typical of what happened in other states. 35/

The rate ceilings imposed on credit insurance by the state are often called "prima facie rates." Insurers may sell credit insurance at or below the prima facie rates; they may not, however, exceed those rates. In 1975, the Missouri Division of Insurance promulgated regulations that, for the first time, would have established a prima facie rate for credit life insurance of $0.75/$100 of initial coverage. The regulation forced down the credit life rate by 25 percent from the $1.00/$100 of coverage, that rate being charged by virtually all underwriters. 36/ Understandably, the new regulations were controversial. The Missouri Insurance Division was sued.

34/ Id. at 39. The NAIC recently increased its recommended loss ratio for credit life insurance from 50 to 60 percent.

35/ See generally, Direct Testimony of C. Donald Ainsworth, supra, at 6-10 (R. 2822-26).

36/ The $1.00/$100 rate was common throughout the country. In some states, underwriters were charging a staggering $1.25/$100 of coverage.

Before that litigation was decided, the Missouri legislature enacted Section 385.070, Mo. Code Ann., a law that limited credit insurance commissions to 40 percent (down from previous rates of 70 and 80 percent) and established a prima facie rate of $0.75/$100 of coverage for a period of three years. After the three years, the Missouri Division of Insurance was authorized further to adjust the prima facie rate (up or down) to achieve the 50 percent loss ratio recommended in the Richmond Resolution.

In 1981, the Missouri Insurance Division conducted a comprehensive inquiry into the loss ratios being experienced by credit underwriters in Missouri. The investigation showed that the prima facie rate for single life decreasing term credit life insurance of $0.75/annum/$100 of initial outstanding indebtedness established by Section 385.070, Mo. Code Ann., had produced average annual loss ratios of 27.9 percent, 30.9 percent, and 34.9 percent for 1978, 1979 and 1980, respectively. Over that three-year period, the average loss ratio for credit life insurance had been a very modest 32.2 percent.

Further calculations revealed that a prima facie rate for single life decreasing term credit insurance of $0.48/annum/$100 of initial outstanding indebtedness would bring about a loss ratio very close to the 50 percent mandated by the new Missouri law. In other words, at the $0.75/$100 rate -- never mind the prior rate of $1.00/$100 -- credit life sellers and underwriters had been deriving stunning excess profits. Notwithstanding the fact that a pure mathematical calculation suggeted a new prima facie rate for single life decreasing term life insurance of $0.48/$100, since the loss experience of underwriters selling credit life insurance appeared to be trending upward, the Division determined that the new prima facie rate for single life decreasing term credit life insurance should be set at $0.60/annum/$100 of initial outstanding indebtedness.

Despite the efforts of most state insurance departments to temper the aggressive overcharging that has been pervasive in the credit insurance industry, the record clearly establishes that the practice continues unabated today. As recently as November 4, 1983, Insurance Commissioner John C. Neff of Tennessee reported to the Tennessee General Assembly on the state of the credit insurance industry in Tennessee. 37/ Commissioner Neff reported that, during 1982, Tennesseeans paid $52 million in credit insurance premiums. Fully $17.2 million of that amount was "excess premiums" (i.e., the difference between the premiums that were charged and the level of premiums that would have produced the 50 percent loss ratio recommended in the Richmond Resolution). $9.5 million of the overcharges went to banks -- many of which are undoubtedly affiliated with bank holding companies. 38/ The ratio of premiums collected to benefits paid was only 33.5 percent, down from the previous year's level of 34.9 percent. In other words, for every dollar paid in by Tennesseans in 1982, they got back only $0.34 in benefits -- $0.66 went to the underwriters and the lenders that sold the insurance. Since the

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37/ The complete report Commissioner Neff provided to the Tennessee General Assembly and the attachment that accompanied that report are provided with these comments as Appendix 1.

38/ See Appendix 1, at 6.

NAIC now recommends loss ratios of 60 percent, Commissioner Neff's overcharge figures are conservative.

Commissioner Neff characterized the credit insurance situation in Tennessee as "outrageous" -- yet, it is typical of the country as a whole. In fact, in states like Alabama, Louisiana and South Carolina, where credit life rates of $1.00/$100 are still permitted, the situation is dramatically worse. 39/ According to the Tennessee Commissioner's calculations, within the next two years, Tennesseans will have overpaid in excess of $100 million for credit insurance in less than a decade. 40/

The sale of credit insurance by lenders is a major source of revenue. The evidence indicates that bank holding companies have been cashing in on the unconscionable profits available through credit insurance sales with as much enthusiasm as all other lenders. Bank holding companies possess an ideal structure for exploitation of credit insurance "monopoly profits." Unlike retailers and automobile dealers, every person who presents himself to a bank is there for one reason -- to borrow money. In addition to banks, the structure of bank holding companies permits them to own finance companies, thereby giving them access to borrowers who may not qualify for bank loans. They are also afforded the chance to reap monopoly profits at both ends of the transaction -- 40 percent commissions at the point of sale and significant underwriting profits resulting from loss ratios at the underwriter level that typically are 30

39/ *Id.* at 7.

40/ *Id.* at 1.

percent or less (i.e., $0.70 or more out of every permium dollar (minus minimal overhead) stays within the bank holding company system).

The evidence adduced in the Missouri cases in 1982 provides a dramatic indication of the financial bonanza that credit insurance represents for bank holding companies. The credit insurance operations of both Commerce Bancshares, Inc. and Mercantile Bancorporation, Inc. have generated enormous profits for those holding companies. In the case of Commerce, for example, its credit insurance subsidiary CBI Insurance Company, experienced a loss ratio of 21.94 percent in 1981 (i.e., $0.78 out of every dollar (minus minimal overhead) stayed in the holding company). CBI had total income of $2,136,147; yet net claims incurred were only $400,891. Net profits of CBI (before taxes) were an impressive $914,076. CBI's expenses included $705,560 in commissions -- commissions that were paid to other affiliates within the Commerce holding company system. 41/ The overall profitability of the credit insurance operation was stupendous -- in a single year, CBI Insurance increased its retained earnings by $923,475, from $3,085,431 to $4,008,906 (30 percent). 42/

Mercantile's credit insurance operation was equally impressive. Mercantile conducted its credit insurance through MBI Insurance Agency, Inc., and a credit insurance reinsurance subsidiary,

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41/ The importance of credit insurance commissions income to the profit centers that receive them cannot be overstated. In 1981, Commerce's Springfield, Missouri bank would have suffered a substantial loss but for the large commissions earned on credit life sales. See Missouri R. 1773-74, 4258.

42/ Direct Testimony of Professor Emmett J. Vaughan, Missouri cases, 57-58 (Missouri R. 2962-63).

Mississippi Valley Life Insurance Company. In 1980, Mississippi Valley incurred claims of $439,847 on premium and investment income of $1,447,216, a loss ratio of 30.4 percent. Net income before taxes and securities transactions was $667,093, not including $335,978 in commissions that were paid to other affiliates within the holding company system. 43/

The credit insurance rates charged by Commerce and Mercantile -- rates over which both holding companies had control -- provide further evidence that both holding companies have aggressively exploited their credit insurance operations to the fullest possible extent. Prior to December 1981, Mercantile sold credit life at $0.75/$100 of coverage, the maximum rate allowed under Missouri law. During the same period, Commerce sold the insurance at $0.70/$100 of coverage, fully 93 percent of the maximum allowable rate. The only reason that Commerce offered any premium concession at all was because the Board's credit insurance regulation required it to do so. 44/ Mercantile avoided having to offer even Commerce's meager premium concession by keeping its reinsurance company as a subsidiary of one of its banks, thereby theoretically avoiding the Board's regulation.

After 1981, Missouri's *prima facie* rate was reduced from $0.75/$100 to $0.60/$100 of coverage. Mercantile reduced the rate for its credit insurance to $0.60/$100, the maximum lawful rate. Commerce reduced its rate to $0.58/$100, 97 percent of the maximum

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43/ *Id.*, at 58-59 (Missouri R. 2963-64).

44/ *See* 12 C.F.R. § 225.4(a)(10) n.10a (1983).

allowable rate. The Missouri litigation unearthed three-year's worth of monthly memoranda sent by CBI Insurance Company to the CEOs of Commerce's banks. 45/ One of those memoranda contains Commerce's reaction to having to make even a small premium reduction -- a reduction that still permitted Commerce to reap enormous credit life profits. That reaction is instructive.

> There are few changes taking place within the industry that you should be aware of. First, the Division of Insurance has recently announced that they will lower the credit life rates within the State of Missouri. CBI Insurance Company will be required to comply with the new regulation as soon as it is published. This new regulation will have a direct impact on the profitability of insurance sales on the individual bank level as well as the profits of CBI Insurance Company. So, it becomes that much more important that we concentrate on increasing our penetration of our insurance products in the future. 46/

At all events, the rates charged for credit life insurance compare most unfavorably with the rate charged in Missouri by Prudential Life Insurance Co. -- $0.375/$100 of coverage, fully 40 percent less than either Commerce or Mercantile. Since Prudential is decidedly not a charitable organization, it must be assumed that, at the lower rate, Prudential is deriving what it considers to be a fair profit for its credit life products.

At trial in the Missouri cases, Insurance Commissioner Ainsworth testified that the 40 percent commissions earned by Commerce and

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45/ Selected excerpts from the Commerce credit life memoranda are provided with these comments as Appendix 2. (Missouri R. 2540-2624 2625-2722, 2723-2803(c)).

46/ Missouri R. 2540-2624 (October 20, 1981)(emphasis added) (Appendix 2).

Mercanitle, while technically lawful, are "totally unrealistic." He also testified that bank holding companies could "certainly sell [credit insurance] for less than they [do] if they want[ed] to." 47/ Obviously, the reason bank holding companies do not reduce the rates they charge for credit insurance is because their principal interest in selling credit insurance is profits maximization, irrespective of what is fair, reasonable and in the best interests of the consumer.

47/ *Missouri* R. 1930 (emphasis added).

c. Tie-ins Between Sales of Insurance and Extensions of Credit

Tying is defined as a situation where the sale of a principal good or service (the tying product) is conditioned upon the customer's purchase of an ancillary good or service (the tied product).

There is a wide variety of conduct that could result in a joint purchase of two products or services (such as credit and insurance). That conduct could range from explicit coercion of the customer by the seller (i.e., "If you don't purchase our insurance, we won't give you the loan.") to a purely voluntary action by the customer with no coercion expressed or implied (i.e., "Do you happen to sell insurance that I can buy to protect my car? If so, I would like to buy it.")

Tying arrangements are deemed to be anti-competitive. In the context of the BHC Act, Section 106 of the 1970 Amendments expressly prohibits bank holding companies from requiring the purchase of ancillary products and services sold in conjunction with extensions of credit. 48/ It is clear that explicit coercion would be a violation of Section 106 of the BHC Act. Where there is absolutely no coercion at all, there is no violation of the BHC Act, even though a joint purchase may occur. The problem is that there is a considerable range of possible actions in between the two extremes. At a minimum, a joint purchase might well occur (i) from an implied or subtle suggestion on the part of the seller, (ii) from a perception on the part of a customer that it would enhance his chances of obtaining

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48/ See 12 U.S.C. § 1972(b) (1982).

the tying product (the loan) from the seller, or (iii) without the customer being aware he had purchased the tied product. Somewhere along this continuum of behavior, a violation of Section 106 of the BHC Act occurs.

In the context of the tying issue, there can be little doubt that, when a consumer presents himself before a lender to receive a loan, there is dramatically unequal bargaining power as between the two. The nature of this problem was stated clearly by the Assistant Attorney General of the Antitrust Division of the Department of the Justice:

> There is clearly a competitive problem here. It exists because a commercial bank enjoys significant market power vis-a-vis a borrower, particularly in times of tight money. This power results from a number of factors, in part, it results from limited entry into banking and the concentrated market structure which tends to prevail in local banking markets. It also rests on the fact that the relation between a commercial borrower and a bank tends to be continuing one with little effective opportunity of "shopping around" for credit: Changing banks is quite inconvenient to the borrower and required considerable disclosure of confidential internal business information necessary for credit evaluation. Finally, the periodic limitations on loan supply imposed by the monetary authorities raises the possibility of informal credit rationing by banks at times of particularly tight money, thereby encouraging the maintenance of a continuing banking relationship, even under normal credit conditions. 49/

The effective opportunity to shop around for most borrowers means, in a sense, that the bank enjoys a quasi-monopolistic position in the eyes of its client. The borrowing relationship tends to be a continuing one, and once a good credit standing with a given bank

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49/ 116 Cong. Rec. S-16315-16317 (Daily Ed. 9-23-70), quoted in Direct Testimony of Emmett J. Vaughan, supra, at 43 (Missouri R. 2948).

has been established, the consumer often feels great compulsion to go to considerable lengths to protect that standing. The fear of being turned down for credit by his own bank creates a situation in which the borrower, at least in his own perception, does not have any alternatives, notwithstanding the existence of competing lenders.

In adopting the 1970 Amendments to the BHC Act, Congress expressed concern not only with the practice of explicit tie-ins, which involved illegal coercion, but also with the "tying effect" which involves voluntary action by borrowers which are not illegal, but which have the effect of producing the same anti-competitive results as if the consumer had in fact been coerced.

The position of the bank as a lender is often sufficient in itself to persuade the borrower that it will be in his best interest to place his insurance with an affiliate of the bank. Even in the absence of coercion, a borrower is likely to believe that he should volunteer to do business with the bank-affiliated agency in order to assure himself that his credit line will remain intact. This means that the bank-affiliated agency need not resort to overt anti-competitive acts to exploit its advantage as a provider of credit, but instead can rely on the voluntary acts of the banker's customers who, eager as they are to protect their access to one of the most vital of important resources (credit), will also patronize the bank's insurance affiliate.

The existence of the power of lenders over borrowers is almost universally accepted. According to a statement filed with the Board by the American Bankers Association ("ABA"):

> Bank related insurance agencies apparently have some advantage over other isurance agencies in soliciting new business, but this advantage is with respect to new insurance which is written at the time a loan is received by the individual from the bank.

Elsewhere in the same document, the ABA goes on to state:

> It is hard to evaluate how potential borrowers view the services of bank-related insurance agencies. For example, John Doe may purchase life insurance from a bank related agency because he feels that his chances for obtaining a future loan are greater if he had purchased other bank services. 50/

One of the most straightforward aknowledgements of the coercive power of banks in the sale of insurance was uttered by the Board itself:

> [B]ecause of the inferior bargaining position of the debtor, he may be susceptible to the loan officer's "suggestions" concerning choice of coverage, premium rates, insuror and agent. As a result, the debtor easily may receive the impression that his loan application may be more favorably considered if he follows such suggestions. 51/

There can be no question that Congress has been fully aware of the tie-in problem in connection with its deliberations on various aspects of the BHC Act. For example, Congress at one point explained:

> Tie-ins occur where a customer is forced or induced to accept other products and along with that product which he seeks. Such tie-ins may

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50/ Vaughan, supra, at 46 quoting "A Brief Survey of the Interrelationships Between Insurance Agencies and Ninth District Banks," at 3, (no author) (Missouri R. 2951).

51/ Hearings on Consumer Credit Insurance Act of 1969 (S. 2764) before the SubComm. on Financial Institutions of the Senate Banking Comm., 91st Cong., 1st Sess. 163 (1969).

> result from actual coercion by a seller or from a customer's realization that he stands a better chance of securing a scarce and important commodity (such as credit) by "volunteering" to accept other products or services rather than seeking them in the competitive marketplace. In either case, competition is adversely affected, as customers no longer purchase a product or service on its own economic merit. 52/

Further on, Congress concluded:

> Section 106 of the [1970 Amendments] which have come to be known as the anti-tie-in section, will largely prevent coercive and reciprocity. But the dangers of "voluntary" tie-ins and reciprocity are basically structural and must be dealt with by the Board in determining the competitive effect of bank holding company expansion in fields closely related to banking when considering applications under Section 4(c)(8). These will be difficult questions, for assurances of good faith and the intention not to engage in tie-ins and reciprocity by the applicant bank holding companies will largely be irrelevant to just as serious dangers of "voluntary" tie-ins and reciprocity. The Board must, in any case, consider these problems in carrying out its responsibilities under the Act. 53/

The concerns expressed by both the Board and Congress have in fact proven to be well-founded. Experience since the 1970 Amendments clearly indicates that lending institutions do indeed have the power to sell insurance in ways that are inconsistent with the public interest. Most often, evidence of coercion in the sale of insurance does not manifest itself in borrower complaints. The very thing that provides the lender with the power to coerce (that is, the lender's power to grant or withhold credit) is likely to make an offended borrower reluctant to make a formal complaint. Furthermore,

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52/ H.R. Rep. No. 1747, 91st Cong., 2d Sess. 18 (1970).

53/ Id.

even if the borrower were to lodge such complaint, actual coercion would be extremely difficult to prove. Again, even if such proof were possible, the amount of money the borrower could reasonably expect to recover in insurance premiums would be negligible -- certainly not enough in most instances for the borrower to risk jeopardizing his relationship with the lender. Under these circumstances, it is hardly surprising that large numbers of complaints have not been made.

Nevertheless, ample evidence does exist that both coercive and voluntary tying do occur. For example, consider the following letter that appeared in testimony before the Senate Banking Committee on S.72 in 1978:

> I regret very much the incident concerning "Mr. X." I based my decision regarding this matter on what I thought to be the best interest of "Mr. X" and the bank. As I indicated to "Mr. X", our bank could not accept the loan unless we were allowed to write the credit life insurance. As I discussed by phone, the primary reason for this request to write the insurance, was because this action increased the return of income on the loan by a good margin. Had our bank been denied this additional income, we could not have approved the loan. Because of the extremely tight credit situation, I feel "Mr. X" would not have obtained the loan elsewhere. Therefore, I believe our bank to be doing "Mr. X" a service by granting this type of loan under these circumstances, with credit as tight at it is at the present.
>
> I can still appreciate and understand your reasoning and regret that "Mr. X" saw fit to cancel his policy with your company. I am hopeful this situation will not occur again in the future. 54/

54/ *Hearings on Competition in the Banking Act of 1977 Before the Comm. on Banking, Housing, and Urban Affairs of the U.S. Senate*, 95th Cong., 2d Sess. 377-78 (1978) (emphasis added).

In 1976, the agency of a Maryland member of the Independent Insurance Agents of America received the following letter:

> Dear Bill: The purpose of this letter is to clear up any misunderstanding that may have arisen as a result of the recent changes in our insurance program. We instructed you to discontinue the automobile dealer's physical damage coverage in the package policies that you have so that we could obtain this coverage coverage through "X" bank. As you know, "X" bank does the financing on our new car inventory. This in no way indicates dissatisfaction of your service or that of the company "X". As I explained to you, we feel that we have to place the coverage with the bank because we so frequently request special favors of them. Even if the premium were to prove a little higher, we would still feel obligated in this way. Please also be assured that this in no way implies that the bank has forced us to make this change in our insurance program. Best regards.

These letters are examples of both coercive and voluntary tying at work. The second letter dramatically illustrates why borrowers are not likely to complain, even if they do feel that they have been coerced. That letter also graphically points out the disincentive that banking institutions have to sell insurance at lower costs. It is clear from the letter that, even if the insurance sold by the bank cost more, consumers may be willing to pay the additional amount simply to protect their credit relationships.

In 1974, the Federal Trade Commission issued a study that revealed that significant amounts of tying exist between sales of insurance and extensions of credit. The FTC study states with respect to one complaint:

> The consumer complaint . . . is typical of the type of credit insurance complaint the

> Division receives from consumers. The complainant, an unmarried attorney, sought to finance the purchase of a car by obtaining a bank loan. He asserts that when he arrived at the bank to pick up his check he was told that no loan would be made unless he "elected" credit insurance. Since the consumer had obligated himself to purchase the car the next day, he signed the insurance election in order to obtain the loan and successfully attempted, at a subsequent time, to obtain a refund of insurance premiums. 55/

The FTC study also provides insight into why few complaints of explicit tying are ever received.

> Once a consumer has signed the credit insurance election, he is without a remedy and has little hope of proving before a court that he did not elect the coverage. Even a complaint to a regulatory agency, including the Federal Trade Commission, will produce action only if the incident is part of an identifiable and deliberate, company-wide pattern of conduct. In addition, the investigation of such practices is a time-consuming one requiring the regulatory agency to gather and analyze insurance sales data and interview large numbers of consumers. Agency action will normally come so late in time as to have no effect on the consumer's own transaction. 56/

Perhaps the best evidence of the lack of incentive of banks and bank holding companies to engage in insurance operations in ways that are consistent with the public interest is provided in the tie-in study published by the staff of the Federal Reserve Board in

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55/ Statement of the Staff of the Division of Special Statutes of the FTC on Credit Insurance Sales Practices and Section 106(b) of the Truth and Lending Act, at 1 (November 1974).

56/ Id. at 2.

February, 1979. 57/ That study purported to show that explicit tying between the granting of credit and the sale of credit related insurance products is "practically nonexistent," and that implicit pressures brought by lenders on borrowers are neither "very strong nor widespread in the industry."

Despite these bald conclusions, the underlying factual information revealed that only a conclusion opposite from that arrived at by the Board staff was really appropriate. For example, the study showed that 62.2 percent of consumers surveyed (almost two-thirds) had in fact purchased insurance in conjunction with an extension of credit, even though such insurance is typically not required as a condition for a loan. Furthermore, more than 25 percent (one out of four) stated that, when credit was extended to them, they were told that the purchase of credit insurance was either required or strongly recommended. Even more telling is the fact that, when the data was analyzed to see what percentage of the consumers who had received "substantial sales pressure" had actually purchased insurance, the percentage went up to 35.9 percent. When one considers that, according to the 1974 Ohio University study, some nine percent of consumers who purchase credit insurance were completely unaware that they have done so, it seems clear that the Board's figures on

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57/ Eisenbeis and Schweitzer, Tie-ins Between the Granting of Credit and the Sale of Insurance by Bank Holding Companies and Other Lenders (February, 1979).

actual penetration rates are substantially understated. 58/ Regardless, the conclusions reached in the Board's tie-in study have been thoroughly discredited. The empirical data adduced by the study, however, continues to speak for itself. Regardless, after holding hearings on the study, Senator Proxmire -- then Chairman of the Senate Banking Committee -- characterized the conclusions arrived at in the study as a "whitewash" of the real facts revealed by the data collected by the study. 59/

On at least one occasion, the FTC has had to initiate proceedings against a finance company subsidiary owned by a bank holding company in order to restrain that holding company subsidiary's aggressive credit insurance misconduct. Guardian Loan Company, Inc. ("Guardian") was a finance company subsidiary of First Jersey National Corporation, a New Jersey bank holding company. In 1976, Guardian entered into a consent decree with the FTC wherein Guardian agreed to cease and desist from a whole series of abusive practices that it had been engaging in with respect to sales of credit life and credit disability insurance. Included among the abuses to which Guardian admitted were (i) misrepresenting, orally and otherwise, that credit life and credit disability insurance was required as a condition to obtain

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58/ Numerous additional criticisms could be made of the Board's tie-in study. In order for the record to be complete, the major detailed criticisms that have been leveled against the Board study are provided with these comments as Appendix 3. Those criticisms make the case that the conclusions of the Board study are invalid while the underlying facts continue to speak for themselves.

59/ Letter from Senator William Proxmire, Chairman, Senate Banking Committee, to G. William Miller, Chairman, Federal Reserve Board, at 2 (July 11, 1979). The full text of Senator Proxmire's letter is provided with these comments as Appendix 4.

credit from Guardian; (ii) discouraging by direct and indirect misrepresentations the declination of credit life and credit disability insurance by borrowers; (iii) representing that the borrowers' failure to elect credit insurance would result in delays in the processing of loans or in the receipt of loan proceeds; and (iv) failing to use the term "amount financed" to describe the amount of credit extended as required by Truth-in-Lending regulations (specifically, the Board's Regulation Z, 12 C.F.R. § 226.8(d)(1)). 60/

The Missouri cases that have been referred to previously, provide the most dramatic evidence possible of the capacity and inclination of bank holding companies to tie sales of credit insurance to their loans. Mercantile had no fewer than 16 banking subsidiaries that had credit life insurance penetration rates of more than 60 percent. Ten of those subsidiaries had penetration rates in excess of 80 percent. One subsidiary had achieved a penetration rate of 98.8 percent. 61/

The penetration data on Commerce was even more dramatic. Fourteen of Commerce's 38 banking subsidiaries had penetration rates in January 1981 of 80 percent or better. Four of Commerce's subsidiary banks had achieved penetration rates of 100 percent.

The Commerce credit life memoranda sent by Commerce's credit insurance affiliate to the CEO's of Commerce's various subsidiary banks urged bank officers in the strongest possible terms to sell

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60/ In the Matter of Guardian Loan, 88 F.T.C. 632 (C-2846, 1976). The full text of the decision in that case is attached to these comments as Appendix 5.

61/ Direct Testimony of Emmett J. Vaughan, supra, at 61 (Missouri R. 2966).

as much credit insurance as circumstances and loan officer ingenuity would permit. A few excerpts from those memoranda provide the flavor the intense interest that Commerce has in maximizing its credit insurance sales:

> CONGRATULATIONS, WE DID IT AGAIN!!!! We topped 1978 sales by 3.4% or near $85,000 in net premium. Total net sales for 1979 were $2,587,029.75. [At 40%, this would produce commission income of slightly $1 Million] FANTASTIC!!! Totals in December show a decrease of 6 penetration points under the previous month resulting in a decrease of $51,828.00 under November, 1978. This is the largest penetration decrease we have experienced this past year. Please remind your lenders when loan demand drops penetration must go up to offset the lower dollar volume of premium sales. 62/

* * *

> With loan demand beginning to pick up again, it is a perfect opportunity to also increase penetration. Penetration continues to be the key to success and increased profits for your bank. 63/

* * *

> As I mentioned before, if we are to increase sales and commissions, we must also increase penetration. Particularly in the last quarter when loan demand tended to slacken . . . . Don King was the "Penetration Agent of the Year" last year. He advised me at the seminar that his goal for 1980 was to win the most coveted award of all, "Retail Agent of the Year." I would suggest to all lenders, if you intend to challenge him, you had better make your move now as we only have three months left in 1980. 64/

The Adminstrative Law Judge in the Missouri cases characterized the evidence presented on the tie-in issue as having been provided

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62/ Missouri R. 2625-2722 (January 11, 1980)(Appendix 2).

63/ Id. (July 8, 1980)(Appendix 2).

64/ Id. (October 10, 1980) (Appendix 2).

by "an impressive array of expert witnesses" whose testimony he had found "quite persuasive." 65/ In fact, on the strength of all of the evidence provided in the record, the Administrative Law Judge concluded that both bank holding companies had been guilty of tying sales of credit insurance to extensions of credit. 66/

D. Evaluation of the Proposal to Eliminate the Board's Premium Concession Requirement From the Credit Insurance Underwriting Regulation

This proceeding is being held because certain of the commentors in the rulemaking proceeding associated with the Board's proposed revision of Regulation Y alleged that the premium concession and policy benefit requirements of the Board's credit insurance underwriting regulation "place[] bank holding company providers of [credit insurance] service[s] at a competitive disadvantage to other participants in the market." 67/ Those commentors also claimed that "no significant evidence of the potential adverse effects considered by the Board eleven years ago has come to light." 68/

The long and well-documented credit insurance record establishes conclusively that credit insurance products are wildly overpriced, even after the inconsequential premium concessions imposed through

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65/ Recommended Decision, Application of Commerce Bancshares, Inc., at 33 (January 12, 1983); Recommended Decision, Application of Mercantile Bancorporation, Inc., at 45-46 (January 12, 1983).

66/ Commerce Recommended Decision at 39; Mercantile Recommended Decision at 51.

67/ 48 Fed. Reg. 53,125, 53,126 (1983).

68/ Id.

footnote 10a of the Board's credit insurance regulation. It is also clear that tie-ins between sales of credit insurance and extensions of credit are common for _all_ lenders, including bank holding companies and their banking and nonbanking affiliates. The driving force behind bank holding company credit insurance practices is _profit_. "Penetration is the Key to Success" -- the catchy motto of Commerce Bancshares' credit insurance operation -- describes what Commerce is doing to consumers to whom it sells credit insurance with a degree of clarity that Commerce probably did not intend. The message in that motto is unmistakably clear -- "Sell as much credit insurance as you possibly can!"

"Reverse competition" works to _increase_ credit insurance premiums, not reduce them. Senator Jake Garn -- Chairman of the Senate Banking Committee and himself an insurance agent for more than ten years -- condemned credit insurance for being exorbitantly priced -- in his words, "ridiculously expensive." _69_/ Mincing no words, on three separate occasions, Senator Garn said flatly that credit insurance is a "ripoff." _70_/

In the face of the market dynamics of the credit insurance industry, the assertion by commentors that footnote 10a places them at a "competitive disadvantage to other participants in the market" is most peculiar and very revealing. The commentors could not have been complaining that the Board is making bank holding companies sell credit insurance at such low prices that no consumers will buy

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_69_/ _See_ 1979 Banking Hearings, _supra_, at 165.

_70_/ _Id_. at 165, 297, 300.

it -- that would be silly. They also could not have meant that the prices at which the Board makes them sell insurance deprives them of the capacity to sell the product at a rate that permits a fair profit -- that simply would not have been true. The only alternative left is that footnote 10a forcibly restrains bank holding companies (however modestly) from *elevating* their credit insurance premiums to the *maximum* levels allowed under the state *prima facie* rates thereby preventing them from being able to pry out of the hapless public even *higher* monoply profits than they are currently earning.

The further claim of the commentors that the potential adverse effects that the Board was concerned about eleven years ago have "not come to light" is errant nonsense.

III. CONCLUSION

Under Section 4(c)(8) of the BHC Act, the Federal Reserve Board has a statutory duty to assure that, if bank holding companies engage in nonbanking activities, they do so in ways that produce net benefits for the public. The Board has the responsibility of regulating bank holding company sales of credit insurance in a manner that results in public benefits. In order for the BHC Act to be meaningful, the benefits that accrue to the public must be *real*, *not illusory*.

These comments comprehensively show that the Board's credit insurance regulation -- even with footnote 10a intact -- permits bank holding companies to underwrite credit insurance at rates that are vastly excessive in terms of the true economic value of the insurance coverage being provided. Moreover, those rates return to the bank holding companies profits that are unconscionable.

The Board's responsibilities under the BHC Act require it to take whatever steps are necessary to assure that the public is treated fairly by bank holding company credit insurance underwriters. Accordingly -- far from eliminating footnote 10a -- the Board should amend its credit insurance regulation to make it truly meaningful. Specifically, the Board should require bank holding companies to determine from state insurance departments the lowest credit insurance rates being charged in the state in question and to meet or better those rates. Doing anything less will mean that, in the face of what is an horrific record, the Board would be lending its imprimatur to the aggressive overcharging of credit insurance consumers that the Board's current regulation permits.

In the face of the credit insurance record that has been presented to the Board, the proposed elimination of footnote 10a of the Board's credit insurance regulation, 12 C.F.R. § 225.4(a)(10)(1983), would be arbitrary, capricious, an abuse of the Board's discretion, and contrary to law.

Respectfully submitted,

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January 24, 1984

APPENDIX 1

Report to the Tennessee General Assembly on Credit Life Insurance

by

John C. Neff

Commission of Insurance

STATE OF TENNESSEE
DEPARTMENT OF COMMERCE AND INSURANCE
114 STATE OFFICE BLDG.
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JOHN C. NEFF
COMMISSIONER

MEMORANDUM

TO: All Members of the General Assembly

FROM: John C. Neff,
Commissioner

SUBJECT: Credit Life Insurance

DATE: November 4, 1983

Once again I am forwarding to you an analysis of credit life insurance sales in Tennessee. The enclosed statistics represent the results for calendar year 1982. These figures show that more than $51,000,000 in earned premiums were charged to Tennessee consumers, of which approximately $17,000,000 is what we consider to be "excess" premiums. The loss ratio between the premiums collected and the total claims paid was 33.5%, even lower than the 34.9% in 1981. In other words, the business was even more profitable though total premiums were somewhat lower due to the 1982 recession. As a matter of comparison, in 1981 the total premiums were $54.4 million and the "excess" profits just under $16.4 million. These "excess" profits are defined as those premiums above that which would produce a 50% loss ratio, and I remind you that the National Association of Insurance Commissioners says 60% is a fair loss ratio. With the upsurge in business activity, particularly in the automobile sector, we would expect a banner year for credit life insurance companies in 1983 and would assume they would make "excess" profits of over $20,000,000.

This is the fifth year that we have attempted to do something about this outrageous situation. From 1979 to 1982 the aggregate "excess" profits totaled $71,000,000. Next year this total should be frighteningly close to $100,000,000. There are only six states in the union charging more than Tennessee, and since March 31, 1983 five states that already have rates below Tennessee have further reduced their rates.

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MEMORANDUM -
October 28, 1983
Page Two

For your information, I am enclosing the following:

(1) A list of all companies writing credit life in Tennessee broken down into both life and disability sales and a calculation for the loss ratio for each company

(2) An analysis of credit life sales by type of creditor

(3) Cost of credit life by state

(4) A list of Tennessee-domesticated companies and a comparison of the non-Tennessee companies

(5) A list of the companies writing in excess of $500,000 of earned premiums in Tennessee

(6) A chart showing premiums, benefits paid and excess premiums on a year-by-year basis since 1976

(7) Several newspaper clippings referring to the sharp increase in automobile sales

We continue to recommend that the price of credit life insurance be lowered in Tennessee. We feel that the pricing of this product should be returned to the Department of Commerce and Insurance where it previously was and where all other insurance pricing is monitored. In this day of higher taxes, inflation, and high unemployment, it seems very unreasonable to take an extra $17,000,000 out of Tennessee consumers' pockets.

The issue has yet to be addressed by the General Assembly and I think the time has come to do so.

hlw

Enclosures

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ALL COMPANIES WRITING CREDIT INSURANCE IN TENNESSEE IN 1982

Company	Life Insurance Earned Premium	Life Insurance Incurred Claims	Life Insurance Loss Ratio	Credit Disability Earned Premium	Credit Disability Incurred Claims	Credit Disability Loss Ratio
Aetna Life	$ 63,485	$ 19,816	31.2%	$ 1,267	$ 743	58.6
Alexander Hamilton	(25,075)	7,631		(1,802)	40,259	
Allstate Life	35,010	27,152	77.6	45,726	7,271	15.9
American Amicable	424,982	159,779	37.6	104,797	20,538	19.6
American Bankers	1,256,454	505,294	40.2	608,626	272,843	44.8
American Centennial				246	402	163.4
American Defender	14,088	(290)		2,247	1,379	61.4
American H & L	224,469	117,766	52.5	350,972	123,939	35.3
American Heritage	121,223	76,600	63.2	88,915	40,899	46.0
American National	109,112	50,030	45.9	47,415	9,222	19.4
American United	77	(1)		0	0	
Andrew Jackson	122,613	18,424	15.0	14,230	24,040	168.9
Appalachian National	1,488,941	787,758	52.9	770,804	673,227	87.3
Arcadia National	2,396	0	0			
Association	41,031	14,281	34.8			
Balboa				475,734	77,707	16.3
Bankers Service	2,079,591	618,462	29.7	679,200	425,114	62.6
Celtic	14	(1)		105	(12)	
Central Guardian	641,623	111,262	17.3	256,274	122,461	47.8
Central Nat'l/Omaha				38,903	26,845	69.0
C. N. Life/Omaha	242,194	88,210	36.4	48,108	25,821	53.7
C. States/Omaha	13,681	11,268	82.5	31,921	(1,362)	
Centurian	51,306	8,052	15.7	53,142	17,672	33.3
Charter National	18,986	4,432	23.3	10,379	2,432	23.4
Cherokee National	1,096,070	345,916	31.6	465,861	232,197	49.8
Chrysler	423,331	98,463	23.3	192,522	97,921	50.8
Citadel	376,524	106,552	28.3	125,776	69,642	55.4
Commercial	11,537	(125)		4,637	5,021	108.2
Connecticut Gen'l.	13,835	(183)				
Consolidated American	239,504	55,195	23.0	19,871	26,602	133.9
Consumer	42,561	10,459	24.6	21,274	10,851	51.0
Continental Assurance	16,115	591	3.7	205	(13,055)	
Continental Bankers	5,755	(301)				
Credit	604,918	237,493	39.3	304,573	157,965	51.8
Cumberland	1,440,358	742,596	51.5	1,149,726	463,781	40.3
CUNA/CUDIS	3,039,355	1,893,296	62.3	3,424,563	1,790,422	52.3
Delta L&A	45,059	14,007	31.1	7,712	2,024	26.2
Dependable	149,843	34,088	22.7	170,855	107,477	62.9
Durham	1,727,137	456,559	26.4	912,295	392,830	43.1
Employers	42,255	9,552	22.6	32,367	9,762	30.1
First Life Assurance	4,192	132	3.1	1,551	0	0
First Federated	4,498	20	0.4	1,031	468	45.4
Firstmark	12,336	6,628	53.7	2,344	100	4.3
First Pyramid	15,351	15,078	98.2	9,563	(2,388)	
Ford	1,099,144	302,830	27.6	565,173	324,525	57.4

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Company	Life Insurance			Credit Disability		
	Earned Premium	Incurred Claims	Loss Ratio	Earned Premium	Incurred Claims	Loss Ratio
Foremost	$ 224,697	$ 92,670	41.2%	77,530	$ 29,671	38.
Founders/FL				2,282	3,199	140.
Georgia Int'l.	466,526	357,432	76.6	183,020	127,997	69.9
Globe L & A	44,431	8,043	18.1	5,961	4,656	78.
Globe Life	2,216,835	521,618	23.5	1,405,240	795,116	56.
Great Commonwealth	18,004	9,109	50.6	700	4,633	661.
Great National	4,953	(133)		7,021	2,710	38.
Gulf Atlantic	1,677,528	444,248	26.5	398,395	205,767	51.6
Gulf Guaranty	377,868	115,383	30.5	83,317	46,541	55.9
Heritage	6,506	14,321	220.1	1,045	0	
Hermitage H & L	9,414	3,598	38.2	7,662	(2,747)	
INA Standard	30,360	31,033	102.2	11,107	8,715	78.
ITT Life	48,911	(1,459)		2,874	8,104	282.
Individual Assurance	4,514	25,000	553.8			
Industrial	111,768	28,865	25.8	88,640	27,514	31.
Integon	341,781	110,504	32.3	130,327	29,082	22.
Investors Heritage	10,610	(4,424)		53	(27)	
John Alden	670,286	245,146	36.6	864,917	197,766	22.
John Hancock	24	16	66.7			
Kennesaw	32,306	11,897	36.8	7,901	2,713	34.3
Kentucky Central	111,596	39,211	35.1	141,296	48,732	34.
Life & Casualty	381,319	157,817	41.4	233,412	27,869	11.9
Life of Alabama	703,876	351,841	50.0	330,093	224,553	68.0
Life Investors	53,628	9,246	17.2	13,656	18,354	134.
Loyal American	93,378	77,209	82.7			
Loyalty	60,433	15,385	64.8			
MIC	383,967	82,525	21.5	115,261	107,795	93.
Maccabees	1,453	(57)		59	(5)	
Main	5,873	0	0			
Massachusetts I & L	172,217	55,218	32.1	19,263	2,854	14.
Metropolitan	(9,247)	9,454		9	851	9455.5
Mid-America	99	0	0	568	0	
Minnesota Mutual	98,910	13,965	14.1			
Montgomery Ward	103,868	52,015	50.1			
Mountain	7,387,137	1,269,937	17.2	1,919,368	738,778	38.
Mutual Savings	169,951	25,217	14.8	46,678	15,678	33.6
National Fidelity	117,555	11,274	9.6	48,228	1,740	3.6
National Old Line	240	0	0			
Nationwide	4,696	(514)		4,253	(582)	
North American L&H	185,408	72,589	39.2	214,081	92,546	43.
North Central	1,367	12	0.9	154	1	0.
Northwestern Security	3,478	139	4.0	1,247	723	58.0
Old Republic	1,431,596	602,057	42.1	266,246	74,355	27.9
Omaha Financial	180,149	121,313	67.3	41,185	16,906	41.

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Company	Life Insurance Earned Premium	Incurred Claims	Loss Ratio	Credit Disability Earned Premium	Incurred Claims	Loss Ratio
P F Life	$ 6,556	$ 438	6.7%	$ 5,706	$ (760)	
Personal	4,503	(1,485)				
Philadelphia	226	360	159.3			
Pilot	67,534	33,492	49.6			
Plateau	1,680,536	471,027	28.1	644,627	138,694	21.5
Protective	129,128	51,557	39.9	42,171	21,981	52.1
Provident Alliance	335,800	64,042	19.1	10,959	4,067	37.1
Provident L&A	41,429	53,843	130.0			
Prudential	624,293	247,549	39.7	118,522	59,735	50.1
Puritan	1,538	(414)				
Security Assurance	276,142	99,785	36.1	106,123	28,831	27.2
Security of America	343,070	111,133	32.4	163,036	71,703	44.0
Shelter	20,514	9,764	47.6	17,226	7,790	45.2
Southeastern Fire				202,617	58,667	29.0
Southern United	253,235	96,418	38.1	131,838	43,372	32.9
Standard	793,362	304,834	38.4	244,809	148,694	60.7
State Farm Life	27,603	7,916	28.7			
State Farm Mutual				79,650	23,979	30.1
Sterling	87,422	53,334	61.0	14,974	21,726	145.1
Stuyvesant	434,957	102,545	23.6	68,046	57,023	83.8
Transamerica Occ.	6,141	166	2.7	2,127	1,181	55.5
Transport	2,093,489	993,537	47.5	2,360	(1,440)	
Travelers	3,335	3,935	118.0			
Twentieth Century				6,400	6,409	100.1
U Life Credit	802,552	319,690	39.8	306,678	166,905	54.4
Union	3,756	0	0			
Union Security	3,129,087	832,415	26.6	1,303,857	573,307	44.0
United Companies	84,583	61,590	72.8	57	53	93.0
United Fidelity	8,868	1,146	12.9	4,552	1,054	23.2
Universal Und.	26,492	6,645	25.1	8,505	(739)	
Vista	4,818	(393)		3,122	2,845	91.1
Volunteer State	3,777,275	940,621	24.9	1,782,777	729,364	40.9
Voyager	895,395	398,810	44.5	1,364,000	451,595	33.1
World Insurance	1,032	0	0			
World Service	58,893	2,513	4.3	24,898	77,811	312.5
TENNESSEE TOTALS	$51,319,212	$17,199,324	33.5	$24,391,814	$11,143,981	45.7

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1982 CREDIT LIFE INSURANCE BY TYPE OF CREDITOR

	Earned Premium	Incurred Claims	Loss Ratio	"Excess Premium"
CREDIT UNIONS	$ 3,700,502	$ 2,246,855	60.7%	$ (793,208)
COMMERCIAL & SAVINGS BANKS	24,307,307	7,388,176	30.4	9,530,955
FINANCE COMPANIES	6,637,495	2,387,976	36.0	1,861,543
MOTOR VEHICLE DEALERS	10,354,206	2,403,600	23.2	5,547,006
OTHER SALES FINANCE	2,517,513	763,347	30.3	990,819
PRODUCTION CREDIT ASSOCIATIONS AND BANK AGRICULTURAL LOANS	3,242,661	1,499,966	46.3	242,729
ALL OTHERS	559,528	509,404	91.0	(459,280)
GRAND TOTAL	$51,319,212	$17,199,324	33.5%	$16,920,563

PRIMA FACIE OR STATUTORY RATE PER $100 OF REDUCING TERM CREDIT LIFE INSURANCE

Premium Rate	States
$1.00	Alabama, Louisiana, South Carolina
90¢	Mississippi
85¢	Oklahoma
80¢	North Carolina
75¢	TENNESSEE, Arkansas, Georgia, North Dakota
70¢	Colorado
44-70¢	Vermont
65¢	Delaware, Illinois, Indiana, Iowa, Kansas, Nevada, New Mexico, West Virginia
64¢	Nebraska
44-64¢	New Jersey
60¢	Alaska, Florida, Hawaii, Idaho, Kentucky, Michigan, Minnesota, Missouri, Montana, South Dakota, Washington
52-56¢	Maryland
55¢	Ohio (effective 11/1/83), Oregon, Virginia
50¢	Connecticut, Massachusetts, Pennsylvania, Texas, Wyoming
40-50¢	California
49¢	District of Columbia, Utah
39.5-47¢ *	New Hampshire
45.7¢	Rhode Island (effective 1/1/84)
44¢	Arizona
43¢	Maine (nominal rate but adjusted annually)
40¢	Wisconsin
34-39¢	New York

(see page 2)

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59.8¢ Total U.S. Average weighted by Credit Life Insurance in force.

* New Hampshire grades rates by type of creditor: Credit Unions 47¢; Banks 42.1¢; Finance Companies 44.6¢; Motor Vehicle Dealers and Other Sales Finance 39.5¢.

Since March 31, five (5) states have ordered a reduction in credit life rates. These states already had rates for credit life lower than Tennessee's.

New Hampshire - From: 47-52¢
To: 39.5-47¢ by type of Creditor

Credit Unions	47¢
Finance Companies	44.6¢
Banks	42.1¢
Motor Vehicle Dealers & Others	39.5¢

Effective 1/1/84

Ohio - From: 65¢
To: 55¢
Effective 1/1/83

Rhode Island - From: 50¢
To: 45.7¢
Effective 1/1/84

Texas - From: 58¢
To: 50¢
Effective 9/1/83

Utah - From: 58-60¢
To: 49¢

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1982 CREDIT LIFE - Continued

NNESSEE COMPANIES

Company	Earned Premium	Incurred Claims	Loss Ratio	"Excess Premiums"
palachian National	$ 1,488,941	$ 787,758	52.9%	$ (86,575)
nkers' Service	2,079,591	618,462	29.7	842,667
ntinental Bankers	5,755	(301)*		6,357
mberland	1,440,358	742,596	51.5	(44,834)
rmitage Health & Life	9,414	3,598	38.2	2,218
ife & Casualty	381,319	157,817	41.4	65,685
untain	7,387,137	1,259,937	17.2	4,847,263
ateau	1,680,536	471,027	28.1	738,482
ovident Life & Accident	41,429	53,843	130.0	(66,257)
lunteer State	3,777,275	940,621	24.9	1,896,033
ennessee Company Total	$18,291,755	$ 5,045,358	27.6%	$ 8,201,039
-Tennessee Companies	33,027,457	12,153,966	36.8	8,719,525
ND TOTAL	$51,319,212	$17,199,324	33.5%	$16,920,564
N % of Grand Total	35.6%	29.3%		48.5%

benefits were paid to Tennesseans in 1982. Furthermore, the company reduced ts claim reserve by $301, resulting in excess premium greater than earned premium.

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1982 CREDIT LIFE

Companies with more than $500,000 of Earned Premium in Tennessee

Rank	Company	Earned Premium	Incurred Claims	Loss Ratio	"Excess Premiums"
1.	Mountain Life	$ 7,387,137	$ 1,269,937	17.2%	$ 4,847,263
2.	Volunteer State	3,777,275	940,621	24.9	1,896,033
3.	Union Security	3,129,087	832,415	26.6	1,464,257
4.	CUNA Mutual	3,039,355	1,893,296	62.3	(747,237)
5.	Globe Life	2,216,835	521,618	23.5	1,173,599
6.	Transport	2,093,489	993,537	47.5	106,415
7.	Bankers' Service	2,079,591	618,462	29.7	842,667
8.	Durham	1,727,137	456,559	26.4	814,019
9.	Plateau	1,680,536	471,027	28.1	738,482
10.	Gulf Atlantic	1,677,528	444,248	26.5	789,032
11.	Appalachian National	1,488,941	787,758	52.9	(86,575)
12.	Cumberland	1,440,358	742,596	51.6	(44,834)
13.	Old Republic	1,431,596	602,057	42.1	227,482
14.	American Bankers	1,256,454	505,294	40.2	245,866
15.	Ford	1,099,144	302,830	27.6	493,484
16.	Cherokee National	1,096,070	345,916	31.6	404,238
17.	Voyager	895,395	398,810	44.5	97,775
18.	USLife Credit	802,552	319,690	39.8	163,172
19.	Standard	793,362	304,834	38.4	183,694
20.	Life of Alabama	703,876	351,841	50.0	194
21.	John Alden	670,286	245,146	36.6	179,994
22.	Central Guardian	641,623	111,262	17.3	419,099
23.	Prudential	624,293	247,549	39.7	129,195
24.	Credit	604,918	237,493	39.3	129,932
		$42,356,838	$13,944,796	32.9%	$14,467,246
	All other companies	8,962,374	3,254,528	36.3%	2,453,318
	Grand Total	$51,319,212	$17,199,324	33.5%	$16,920,564

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NOTE: Attached is a graph detailing credit life insurance experience in Tennessee since 1976. Please note that since 1979, the total premiums collected by credit life companies have not fallen below $50 million, even during the recent recession. With economic recovery taking shape, credit life premiums could climb dramatically, taking even more money from Tennessee consumers.

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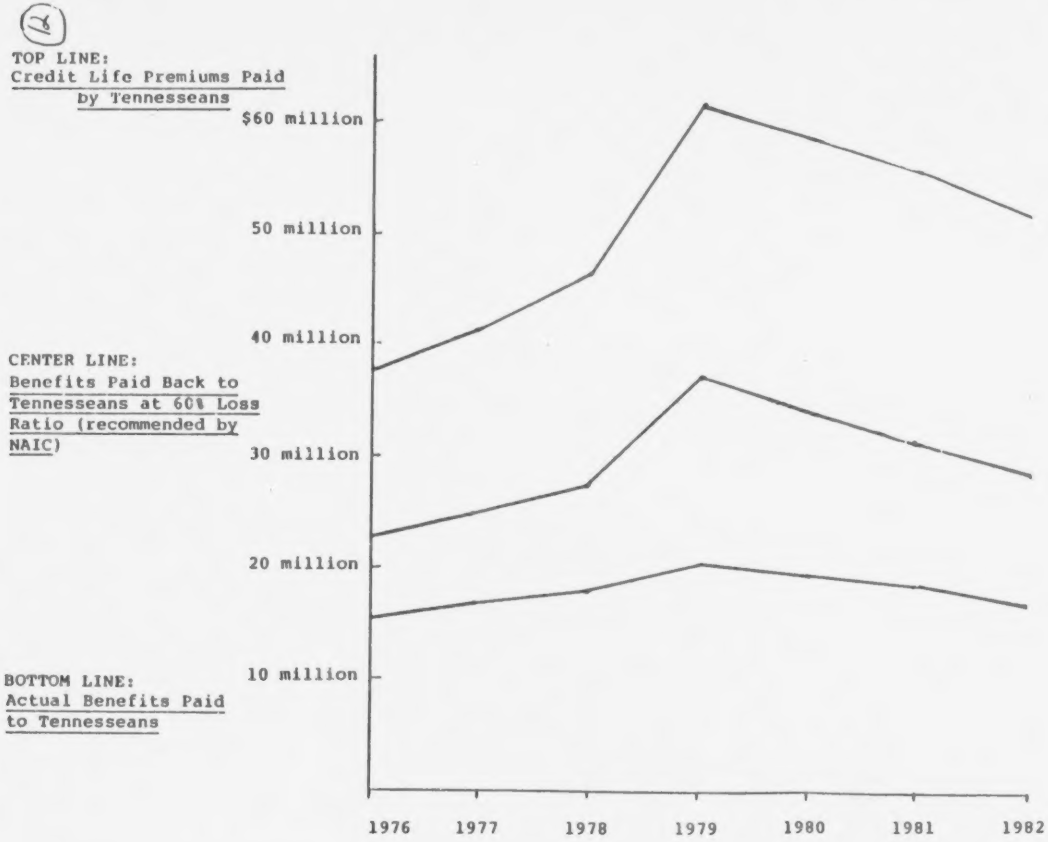
TOP LINE:
Credit Life Premiums Paid by Tennesseans
CENTER LINE:
Benefits Paid Back to Tennesseans at 60% Loss Ratio (recommended by NAIC)
BOTTOM LINE:
Actual Benefits Paid to Tennesseans
$60 million
50 million
40 million
30 million
20 million
10 million
1976
1977
1978
1979
1980
1981
1982

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NEWSPAPER CLIPPINGS FROM THE TENNESSEAN

Big Three's Auto Sales Rise 19.8%

By MICHELINE MAYNARD
UPI Auto Writer

DETROIT — The Big Three automakers reported yesterday a 19.8% gain in sales for the middle 10 days of August, a jump made smaller than expected by growing shortages of 1983 models.

Industry totals were not immediately available because Honda of America figures could not be obtained.

THE TOP THREE companies' combined sales for the Aug. 11-20 period were 152,663, up 19.8% from 127,425 last year. For the month, sales by the Big Three arv up 29.5% from last year. So far this year, the top three firms have seen sales go up 16%.

Analysts were expecting an increase of around 35% to 40%. But with a month left in the 1983 model year, some dealers are running out of cars. Buyers, too, are deciding in some cases to wait until the new autos are in.

Ford Motor Co. had the best performance of the Big Three during the 10-day period, with sales up 23.6% to 36,769 from 29,736. The No. 2 automaker reported sales up 34.2% so far in August. Ford sales for the year are up 12.3%.

Ford has not offered sales incentives since the beginning of August.

GENERAL MOTORS CORP. had an 18.5% increase in sales for the 10-day period. It sold 96,720 autos compared to 81,587 last year. GM sales for the month are up 27% and are up 15.3% for the year.

Chrysler Corp. saw mid-August sales go up 19.2% despite the end of an incentive program on Aug. 10.

Chrysler sold 19,174 autos compared to 16,092 last year. Chrysler sales for August so far are up 34%. The No. 3 automaker is reporting a 26.4% increase in sales so far this year.

Among the smaller companies, American Motors Corp. had a 115.1% increase in mid-August sales, selling 4,300 cars compared to 1,999 a year ago. AMC sales so far this month are up 118% and are up 113% so far in 1983.

Volkswagen of America had a 15.7% decline in mid-August sales. VW sold 2,049 autos compared to 2,431 last year. VW sales for the month are down 25.8% and are down 10.7% so far this year.

Experts See Automobile Sales Hike

By ANN JOB WOOLLEY

DETROIT (AP) — Auto analysts predicted yesterday that the 1984 model year will be even better than 1983, with sales of domestic and imported cars expected to rise to the first 10 million mark since 1979.

Consumers will continue to snap up the larger cars as well as luxury and high-priced models, analysts said.

THE AUTO industry specialists said between 7.4 million and 8 million U.S.-made cars could be sold in the new model year that began this week, up at least 14.4% from 1983's 6.47 million vehicles.

Imports, with sales of 2.3 million in 1983, could rise to 2.5 million next year, or up 8.7%, they said.

Most analysts assume some liberalization in voluntary import restraints now limiting the Japanese to sell 1.68 million cars in this country per year. The restraints expire next March.

THE INDUSTRY'S last 10-million-car year was 1979, when 10.8 million autos were sold just as a four-year sales slump was getting under way.

The 1978-model year set the record with sales of 11.1 million cars.

"In terms of the number of cars being sold this year (calendar 1983), the numbers are very, very modest," said Philip K. Fricke, analyst at Goldman, Sachs & Co. in New York. "It was an extraordinary downturn we went through — the period of the downturn was 17 quarters. We have a lot of catching up to do."

He predicted sales increases for 1985 as well.

BUT JOSEPH S. Phillippi, analyst at Dean Witter Reynolds in New York, noted that his 15% projected increase in 1984 sales will come "only if we get a steady grinding away of interest rates and a somewhat more robust economy than most are forecasting."

The analysts agreed that consumers will continue to prefer larger cars, a trend that began in 1982 after gasoline prices stabilized.

"The declines in oil prices have caused customers across the board to be less concerned with fuel economy," said Harvey Heinbach, analyst at Merrill Lynch, Pierce, Fenner & Smith Inc. in New York.

HE NOTED, however, that the top seller in the 1983-model year was the Ford Escort subcompact, indicating there are buyers who are "much more interested in price and fuel economy."

The second-best seller was the large Oldsmobile Cutlass Supreme followed by the full-size Chevrolet Caprice-Impala models and the large Oldsmobile Delta 88.

(14)

Car Sales in July Jump 39%; GM Leads

By MICHELINE MAYNARD
UPI Auto Writer

DETROIT (UPI) — The nation's automakers, led by General Motors Corp., reported a 39.5% increase in July sales yesterday and posted a 38% increase in the final 10 days of the month.

In July, sales were 576,865, up 39.5% on a daily basis from 429,908 last year. The annual selling rate for the period was 7.5 million cars, compared to 5.3 million in July 1982.

IN THE final 10 days, sales rose 37.9% on a daily basis to 234,386 compared to 188,734 last year. The selling rate per day was the highest since 1979.

So far this year, automakers have sold 3,903,566 cars, up 16.6% on a daily basis from 3,364,730 last year.

The Big Three reported an increase of 38.8% for the month. Big Three sales rose 37.1% for the period and are up 15% for the year.

GM SOLD 347,966 cars in July, up 46.1% on a daily basis from 247,602 last year. GM sales in the final 10 days of the month rose 44.2%. They are up 14.5% so far this year.

Chrysler Corp. reported a 41% increase on a daily basis in July sales. The No. 3 automaker sold 74,785 cars versus 55,052 last year. Chrysler sales in the final 10 days rose 49% and are up 26% for the year.

Ford Motor Co. reported a 21.2% increase in July sales on a daily basis. Ford sold 129,358 autos compared to 110,988 last year. Ford sales in the final 10 days were up 17% and are up 10.9% for the year.

American Motors Corp. reported a July increase of 74% on a daily basis. AMC sales in the final 10 days rose 85.4%. Its sales so far this year are up 113.4%.

Volkswagen of America had a 19.2% drop in July sales on a daily basis. VW sold 6,144 cars versus 7,908 last year. VW sales for the period dropped 9% and are down 9.3% for the year.

Consolidated Report of Conditio

Auto Sales Beat '82 by 40.8%, Best Since '79

(Continued From Page One)

Early August's annual rate compares with last year's sales of 5.76 million domestic cars, the worst year since 1961.

GM said it sold 109,189 cars between Aug. 1-10, or 12,132 per day, compared with 71,473, or 8,934 a day in the year-earlier period.

FORD WAS up 46.9%, from 23,530, or 2,941 per day, to 38,880, or 4,320 per day.

Chrysler sales climbed 50.7%, from 13,676, or 1,709 per day, to 23,183, or 2,576 a day.

AMC estimated 3,900 cars sold in the period, or 433 per day, compared with 1,900, or 237 a day, in the year-earlier period.

VW SHIPPED 1,638 cars, or 182 per day, compared with 2,260, or 282 per day, a year earlier.

American Honda Manufacturing Co. Inc. sold 1,896 cars in early August. The firm did not produce cars in the United States at this time last year.

So far this year, the carmakers have delivered 4,090,577 autos, a 23.4% gain over last year's 3,477,569.

GM's tally is 2,440,482, up 15.2% from 1982's 2,118,110. Ford sales are up 11.9% from 1982's 828,215 to 926,501. Chrysler has improved 26.8%, from 418,706 to 530,782. AMC's sales have risen 111.6% from 1982's 56,243 to 119,027. VW is down 10.4%, from 56,295 to 50,423. Honda's tally is 23,362.

Ford Tells 2nd Quarter Profits of $542 Million

July

DEARBORN, Mich. (UPI) — Ford Motor Co. reported second quarter profits of $542 million yesterday and Chairman Phillip Caldwell declared the company is "on a roll."

The net income, amounting to $4.50 a share, is $337 million higher than the same period of 1982 and $331 million higher than the first quarter of 1983.

"I BELIEVE it would be fair to say Ford Motor Co. is on a roll," Caldwell said. "We've beat out a little clearing in the jungle and the sunshine feels good."

Ford's showing raises the combined quarterly profits of the Big Three automakers to nearly $1.9 billion. General Motors earlier reported a $1.043 billion profit while Chrysler Corp. said it made $310.3 million.

Caldwell said he expects the year's domestic car market to top 9 million and to exceed that next year if federal deficits do not "stop the recovery dead in its tracks."

"I CAN EASILY see, if we don't muck it up, over 10 million next year," he said.

Asked about a recent study that predicted little growth for Ford, Caldwell said, "Analysts expected us to announce $400 million instead of $542 million."

He said if things go as well the rest of the year employees would receive a profit-sharing payout.

"THEY'VE EARNED it, they deserve it, and if the economic recovery holds up, they'll get it," he said.

Caldwell credited the improvement to further gains in Ford's car and truck business in North America, higher car industry volume, a bigger market share in Europe, and worldwide productivity improvements.

"I want, in particular, to draw your attention to our U.S. operation," he said.

"THIS HAS BEEN the biggest single challenge we have faced in recent years, and we are now solidly in the black. Three-fourths, or $406 million of our second quarter profit, was earned in the United States. This is up from $23 million last year, and factory sales are up only 1 percent."

Ford's net income for the second quarter of 1982 was $204.9 million, or $1.70 a share. For the first half of 1983, Ford made $753.4 million dollars, or $6.25 a share, compared with a loss of $96.6 million, or 80 cents a share, in the first half of last year.

Sales surpassed $11.7 billion in the second quarter of 1983, compared with $10.98 billion for the same period of 1982. For the first six months of 1983, sales totaled $21.7 billion, up from $19.8 billion in 1982.

Sales of U.S. Cars Up 45% Over 1982

DETROIT (AP) — Domestic automakers opened the new model year in strong fashion, with sales in early October climbing 45% from depressed levels a year ago, the companies said yesterday. Customer interest in new models and improving inventories on dealer lots helped spark the increase, analysts said. The six major U.S. automakers reported selling 191,965 cars in the Oct. 1-10 period, up from 132,386 a year earlier. Increases for the period reported by the Big Three automakers were General Motors Corp., up 47%; Ford Motor Co. up 67.8%; and Chrysler Corp. up 11.3%.

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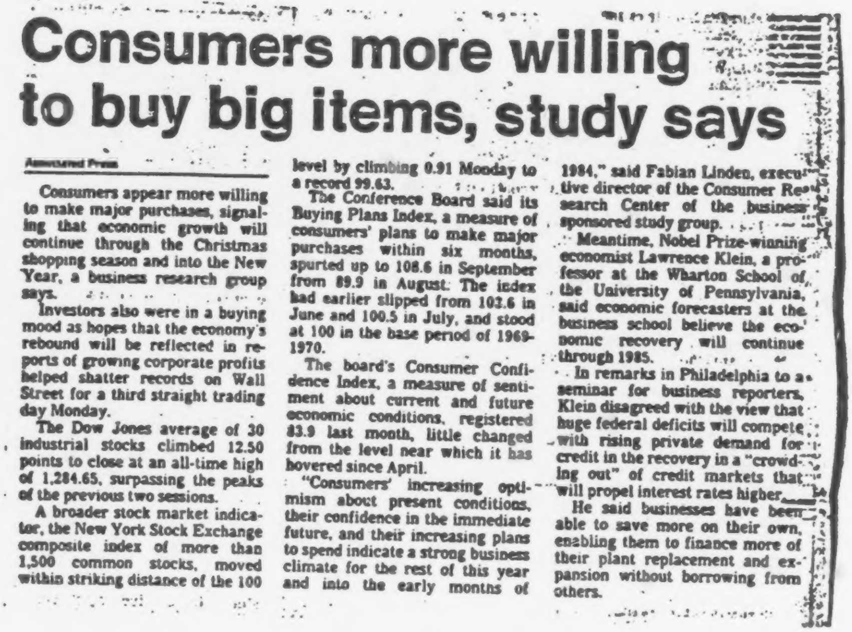

Consumers more willing to buy big items, study says

Associated Press

Consumers appear more willing to make major purchases, signaling that economic growth will continue through the Christmas shopping season and into the New Year, a business research group says.

Investors also were in a buying mood as hopes that the economy's rebound will be reflected in reports of growing corporate profits helped shatter records on Wall Street for a third straight trading day Monday.

The Dow Jones average of 30 industrial stocks climbed 12.50 points to close at an all-time high of 1,284.65, surpassing the peaks of the previous two sessions.

A broader stock market indicator, the New York Stock Exchange composite index of more than 1,500 common stocks, moved within striking distance of the 100 level by climbing 0.91 Monday to a record 99.63.

The Conference Board said its Buying Plans Index, a measure of consumers' plans to make major purchases within six months, spurted up to 108.6 in September from 89.9 in August. The index had earlier slipped from 103.6 in June and 100.5 in July, and stood at 100 in the base period of 1969-1970.

The board's Consumer Confidence Index, a measure of sentiment about current and future economic conditions, registered 83.9 last month, little changed from the level near which it has hovered since April.

"Consumers' increasing optimism about present conditions, their confidence in the immediate future, and their increasing plans to spend indicate a strong business climate for the rest of this year and into the early months of 1984," said Fabian Linden, executive director of the Consumer Research Center of the business-sponsored study group.

Meantime, Nobel Prize-winning economist Lawrence Klein, a professor at the Wharton School of the University of Pennsylvania, said economic forecasters at the business school believe the economic recovery will continue through 1985.

In remarks in Philadelphia to a seminar for business reporters, Klein disagreed with the view that huge federal deficits will compete with rising private demand for credit in the recovery in a "crowding out" of credit markets that will propel interest rates higher.

He said businesses have been able to save more on their own, enabling them to finance more of their plant replacement and expansion without borrowing from others.

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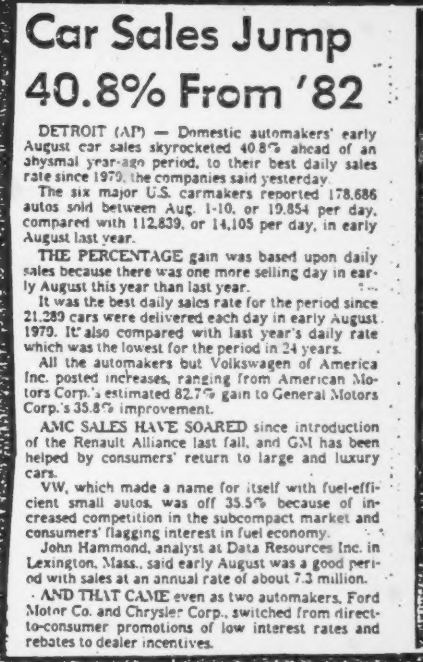

Car Sales Jump 40.8% From '82

DETROIT (AP) — Domestic automakers' early August car sales skyrocketed 40.8% ahead of an abysmal year-ago period, to their best daily sales rate since 1979, the companies said yesterday.

The six major U.S. carmakers reported 178,686 autos sold between Aug. 1-10, or 19,854 per day, compared with 112,839, or 14,105 per day, in early August last year.

THE PERCENTAGE gain was based upon daily sales because there was one more selling day in early August this year than last year.

It was the best daily sales rate for the period since 21,289 cars were delivered each day in early August 1979. It also compared with last year's daily rate which was the lowest for the period in 24 years.

All the automakers but Volkswagen of America Inc. posted increases, ranging from American Motors Corp.'s estimated 82.7% gain to General Motors Corp.'s 35.8% improvement.

AMC SALES HAVE SOARED since introduction of the Renault Alliance last fall, and GM has been helped by consumers' return to large and luxury cars.

VW, which made a name for itself with fuel-efficient small autos, was off 35.5% because of increased competition in the subcompact market and consumers' flagging interest in fuel economy.

John Hammond, analyst at Data Resources Inc. in Lexington, Mass., said early August was a good period with sales at an annual rate of about 7.3 million.

AND THAT CAME even as two automakers, Ford Motor Co. and Chrysler Corp., switched from direct-to-consumer promotions of low interest rates and rebates to dealer incentives.

CREDIT LIFE INSURANCE IN TENNESSEE

Dollar Amounts in Millions

Year	Earned Premium	Incurred Claims	Loss Ratio	"Excess Premium"	Accumulation from 1979
1976	$38.134	$15.069	39.5%	$ 7.996	
1977	40.472	15.168	37.5	10.136	
1978	46.437	16.449	35.4	13.539	
1979	60.145	20.518	34.1	19.109	$ 19.109
1980	58.138	19.347	33.3	19.444	38.553
1981	54.438	18.999	34.9	16.439	54.992
1982	51.319	17.199	33.5	16.920	71.928

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WHY CREDIT LIFE RATES MUST BE REDUCED:

1. Tennessee has the fifth highest rate in the nation: Despite our position on the lower end of most economic indicators, only six states allow higher charges for credit life insurance than Tennessee. In 1981 the National Insurance Consumer Organization said in a special bulletin that the regulation of credit life insurance "has not been one of state regulation's finest hours." That fact has not changed where Tennessee is concerned. Five states whose allowable rates were already lower than Tennessee's this year ordered further reductions.

2. Auto sales are up and the economy is improving: For years the "justification" made by some for high credit life rates has been that auto dealers in particular were being hurt by the recession. Auto sales are rebounding. It is terribly unfair for auto dealers, banks or anyone else to be allowed to charge unconscionably high rates for credit life, recession or no recession. But, now that sales have gone up, there is no reason that credit life rates should not come down.

3. No one says we're wrong: Throughout our five-year attempt to get these rates reduced, not one person has called, written or visited with us to say that we are wrong, that credit life rates are not unfair. They are unfair, and we challenge anyone with an interest in this subject to come forward in a public forum and attempt to justify these rates.

4. It will give Tennesseans a huge financial break: Since 1979 when we began our efforts to reduce credit life rates, our citizens have been charged some $71 million dollars more than they should have had to pay for this product. Tennessee's credit life rates are a totally unjustified burden for our people to bear.

5. Other life insurance rates are coming down: Since the end of World War II, life insurance rates in general have been on a steady downward course. Our law allows credit life rates to be maintained at unreasonably high levels, to the detriment of our people.

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JOHN C. NEFF
COMMISSIONER

NEWS From
Dept. of Commerce and Insurance

FOR IMMEDIATE RELEASE NOVEMBER 9, 1983 - 225

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Information Director
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NASHVILLE - In the opinion of John C. Neff, Tennessee Commissioner of Commerce and Insurance, state law allowed Tennesseans to be "overcharged" almost $17 million for credit life insurance in 1982.

Since 1979, Tennesseeans have paid some $71 million more than they should have had to pay for credit life insurance, Commissioner Neff said.

"It's a shame that our people are treated this way, but the legislature has consistently and repeatedly refused to do anything about this situation," Neff said.

Credit life insurance pays the balance of a loan if a borrower dies. For example, if a buyer finances a new car and covers the loan with credit life insurance, the loan would be paid off if he or she dies.

"I have said over and over again that the only thing wrong with credit life insurance in Tennessee is the price," Commissioner Neff said. "It is too high by any measure or indicator you use. It is costing our people an enormous amount of money that should be staying in their pockets."

The present law says that rates are reasonable if they do not exceed 75 cents per $100 of coverage for single premium decreasing term and $1.38 per $100 for single premium level term.

"This may not sound like much," the Commissioner said, "but on a car loan or some other types of loans it means hundreds - even thousands - of dollars."

The state legislature controls the price of credit life insurance. The rate is set by statute, and it is the only insurance product in Tennessee that is not under the pricing authority of the Department of Commerce and Insurance.

"What we have asked for four years - and what we will continue to ask - is that the legislature return the pricing of credit life insurance to this department," Neff said. "If it does, we will set a fair rate,

- More -

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a rate that will not take advantage of the state's citizens."

In 1982, companies with credit life insurance collected $51.3 million in premiums from Tennesseans and paid out only $17.2 million in benefits, a loss ratio of 33.5 percent.

Of the nearly $17 million in "excess" premiums, as the commissioner calls them, $9.5 million went to banks and $5.5 million went to car dealers.

For years, Neff said, one of the main arguments made against the pricing authority to the department has been that credit life rates provide big profits to automobile dealers, who were hurt by the recent recession.

"In the first place, I never agreed that Tennesseeans should pay ridiculously high rates for the benefit of car dealers, banks or anyone else," the Commissioner said. "But now, when all indicators point to car sales making a strong recovery, there is no reason that the 'plight' of the car dealers should continue to be used as an excuse to keep rates high."

Since March, 1983, five states whose rates were already lower than Tennessee's have ordered even further reductions, Neff said.

"Tennessee, despite being on the low end of most economic indicators, allows the fifth highest rate for credit life in the U.S.," according to Neff. "That's not a noble distinction.

"Last year we missed by only one vote from passing the bill out of the Senate Commerce Committee," Commissioner Neff said. "That's the best this bill has ever done, and maybe this year it will receive enough support to move it along."

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APPENDIX 2

COMMERCE BANCSHARES, INC.
VERBATIM QUOTATIONS FROM CBI INSURANCE MEMORANDA TO CEOs OF SUBSIDIARY BANKS

February 7, 1979

Typically loan demand is somewhat slack during the month of January, but I noted penetration statistics were also down which would indicate in many cases that we were not producing up to our normal performance which proves once again "penetration is the key to success". When the penetration drops, so does our profit.

It is imparitive [sic] that each of your commercial lenders submit an individual performance report on the 20th of each month as we intend to add another agent of the year award this year. It will be called "The Commercial Agent of the Year Award" based entirely on top dollar of level term sales.

We are still making plans for our insurance recognition seminar to be held at the Lodge of the Four Seasons on May 4th, 5th and 6th, 1979. Please advise your lenders who qualified to shine up their golf clubs, tennis racquets and to pack their swim trunks."

March 9, 1979

. . . I noted the Level Term sales increased over $3,000, a total of $7,584.46. This is a tribute to our Commercial Lenders who, for the most part, have not been very active in our Insurance Program. This proves it can be done with very little effort on the part of the Commercial Lenders. In my January report I noted we had 17 banks who did not generate a Level Term sale. This figure was reduced down to 4 this month.

May 10, 1979

. . . WE DID IT!!! We toped April of 1978 sales by $15,000.00. Net sales for April 1979 were $265,975.44. Net commissions were $107,080.34.

This figure of over one-quarter million dollars is our highest month, year-to-date, and also breaks our previous record of July, 1978, by nearly $10,000. This is a terrific accomplishment for our Company and is a credit to all of our lenders. I am sure I am speaking for all of the officers of the Holding Company when I say "Please extend my congratulations to all your lenders". I recent had the opportunity to review penetration statistics. I noted penetration increased 19 points for the year 1978 over 1977. As you can see by the increase in volume so far this year, "penetration is truely [sic] the key to success."

Level term sales were up $2,560.00 over the previous month. This figure still represents only 4% of our total sales. It appears the only way we can increase this figure to a respectable 10% is for the CEO's of the 10 non-productive banks to visit with your commercial lenders at your next staff meeting, requesting that they show the same cooperation and support of our insurance program as your installment lenders do."

July 3, 1979

Insurance premiums produced in June were $280,600. One of the best production months our company has achieved. Net bank commissions paid in the month were $113,314, an impressive figure that adds nicely to the profit line of your banks. It appears now at mid-year, that sales could easily surpass $2.8 million in 1979. Bank commissions reaching in excess of $1 Million will become a principal source of revenue for the banks that are active producers.

August 3, 1979

I find it hard to believe that there is a bank in our system that cannot generate at least one level term policy in a 30-day period. This indicates to me the commercial lenders of the nine nonproducing banks are not attempting to sell this program, and I am asking you and your Regional Vice Presidents for assistance on this matter. The commission from the sale of our level term program is one way of improving the yield of your single pay loans, which at today's rates and cost of funds, could be a deciding factor as to whether the loan is profitable or not.

September 6, 1979

It is hard to believe a bank that does a good job promoting our single life and accident and health program cannot sell one joint life policy. Please call this to your lenders' attention at your next staff meeting. If we are going to continue our present growth pattern, we must continue to increase our penetration.

* * *

Continue the good work - concentrate on penetration and your premium sales will increase which will naturally increase your bank's profit.

October 5, 1979

Some lenders have already qualified, many are getting close, but with only 55 working days left it will be imperative that many of the lenders maximize their sales efforts if they plan to attend the recognition seminar next spring.

December 7, 1979

Festus, Lebanon and Brunswick were leaders respectively in the penetration area. I noted that a number of the banks are slipping in this category as overall penetration appears to be rather low. With sales rather slow during the next 60 to 90 days, it would be wise to mention this to your lenders. A respectable penetration must be achieved if you are to maximize profits from sales.

January 11, 1980

CONGRATULATIONS - WE DID IT AGAIN!!!! We topped 1978 sales by 3.4% or near $85,000 in net premium. Total net sales for 1979 were $2,587,029.75. [At 40% commission, this would produce commission income of slightly over $1 million.] FANTASTIC!!! Totals in December showed a decrease of 6 penetration points under the previous month resulting in a decrease of $51,828.00 under November, 1978. This is the largest penetration decrease we have experienc this past year. Please remind your lenders when loan demand drops penetration must go up to offset the lower dollar volume of premium sales.

February 7, 1980

As installment loan demand continues to decrease so does your insurance income. In order to offset this loss of income we must continue to improve our penetration of Level Term sales on single payment loans. As you are aware, most of your installment loan departments do a good job in the sale of our insurance products, but the commercial loan departments have not begun to penetrate their market. In fact, eight of our banks did not sell one Level Term policy last month. This market is an ideal source of additional income that will bring your bank sales back to a respectable dollar level.

* * *

Remember, penetration of available loans is the key to your bank's insurance success and profits. A good goal to establish for your bank would be a penetration total of 200 points on a possible scale of 300 points.

March 11, 1980

February totals were $144,206 - a respectable figure considering the present economic conditions. I noted we improved our overall penetration by 2 points which resulted in an increase of net sales of better than $22,000 over the previous month, which proves once again, "Penetration is the key to success." I understand many of our affiliates are fighting hard to keep their earnings at a respectab level. The sale of our Credit Life program can be one of the solution to the problem.

Enclosed is an Analysis of Incremental Income and Yield from Credit Insurance Program. As you can see from the example, a simple $5,000 installment loan based on a APR of 16.24 for 36 months at a 40% commission, your incremental yield can be increased by 2.65%. This same theory will also apply to your commercial and real estate loans. With prime rate at 17.3/4%, the sale of our insurance products is a solution as to how you can justify a loan, profitwise, in today's market. Please discuss this with your staff at your next loan meeting

April 3, 1980

With installment lending being slowed down, it is still possible to generate respectable bank commissions through level term sales. Take advantage of this OPPORTUNITY!!!.

July 8, 1980

With loan demand beginning to pick up again, it is a perfect opportunity to also increase penetration. Penetration continues to be the key to success and increased profits for your bank.

August 6, 1980

As you know, we are into what has in the past been known as our best lending months. Loan demand has been slowly increasing, and will hopefully continue in that direction the remainder of the year. It is important to remember that penetration of insurance sales should also increase accordingly. We are already in the planning stages for our 3rd annual Insurance Recognition Seminar,

(8/6/80, cont'd)

and there is still a lot of time left for many of you to qualify. But to do so, you must think insurance, think penetration, think profits! Good luck!

September 4, 1980

Hopefully, this last month's sales increase is an indication of more good things to come. Loan demand appears to be picking up considerably, and with that, I am glad to see most of the lenders are taking the opportunity to increase penetration of our insurance products. We still have four months to go, and I am looking forward to more of you qualifying each month for one of our insurance clubs.

October 10, 1980

As I mentioned before, if we are to increase sales and commissions, we must also increase penetration. Particularly in this last quarter when loan demand tends to slacken. . . . Don King was the "Penetration Agent of the Year" last year. He advised me at the seminar that his goal for 1980 was to win the most coveted award of all, "Retail Agent of the Year". I would suggest to all lenders, if you intend to challenge him, you had better make your move now as we only have three months left in 1980. As you can see, many lenders have already qualified for one of our insurance clubs and several more are close.

November 10, 1980

Big Four penetration leaders continue to be familiar names this month with Brunswick leading the way with 261 points (an increase of 49 points over last months total). Ed Lewis and his staf obviously see the importance of increasing penetration as a valuable tool in increasing profit particularly in a smaller loan portfolio and more importantly, when loan demand is down.

January 12, 1981

A decrease in penetration was also experienced, resulting in a 10 point reduction from 159 last month to 149 for December. Understandably, with this kind of decrease in penetration, bank commissior

(1/12/81, cont'd)

are also adversely affected. This month's commissions decreased $17,635.50, for a total of $48,924.23. Please remind your lenders when loan demand drops penetration must go up to offset the lower dollar volume of premium sales.

February 9, 1981

As always, penetration is a big factor in our efforts to increase insurance income. Although we are experiencing a decrease in actual loan demand, I am pleased to see our overall penetration has not been drastically affected. . . . Remember, even though loan demand is down, insurance income can be maintained through Level Term sales on renewed single pay notes.

March 9, 1981

Since penetration fell only 1 point to 147, which is our affiliate bank average for last year, the fantastic increase in sales this month must be due to an increase in actual loan demand. Something we have all been waiting for! With installment lending beginning to pick up, this would be an excellent time to work on increasing our overall penetration.

April 10, 1981

A question has been brought to my attention regarding the original amount of life insurance on Simple Interest loans. The Monroe calculators which are now being used throughout the system are programmed to include the interest in the original amount of life insurance . . . for those loans not processed on LPS, remember to include the interest in the total amount of insurance in force and type your certificate for the amount of the total of payments, not the amount financed.

May 22, 1981

It has recently been brought to my attention by Commerce Bancshares legal staff, that all insurance sold in our affiliates must be loan related, and must not be for more than the original note amount. Please discuss this with your lending personnel.

July 17, 1981

Although we continue to struggle through this period of seemingly decreased loan demand, insurance sales in all of our categories are surprisingly well above last year's totals for this same period of time. It is apparent that our lending officers have become more familiar and more confident with the products that we have to offer our customers and their efforts are appreciated.

October 20, 1981

I realize that loan demand continues to be at al all time low, however, this is the time when we must take advantage and increase penetration on the loans we are making. Remember, we have pointed out several times in the past that "penetration is the key to success" in generating additional income for your bank while offering valuable protection to your customers at the same time. Please remind all of your lenders to take this opportunity in an effort to maintain a consistent level of penetration.

* * *

There are a few changes taking place within the industry that you should be made aware of. First, the Division of Insurance has recently announced that they will lower the credit life rates within the State of Missouri. CBI Insurance Company will be required to comply with the new regulation as soon as it is published. This new regulation will have a direct impact on the profitability of insurance sales on the individual bank level as well as the profits of CBI Insurance Company. So, it becomes that much more important that we concentrate on increasing our penetration of our insurance products in the future.

November 12, 1981

Year-to-date premiums total approximately $1.7 million. In order to reach our goal of $2 Million in Net Premiums for 1981 and surpass last year's total, we will need to average $150,000 per month for the remainder of the year. I know this goal can be achieved with your continued support.

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APPENDIX 3

Principal Criticisms
of the
Federal Reserve Board's Tie-In Study

by

Emmett J. Vaughan, Ph.D. (IIAA)
Lewis H. Goldfarb (FTC)
David H. Pyle (OCC)

SUMMARY AND PAPER

The Federal Reserve Board's Tying Study: A Critical Analysis

by

Emmett J. Vaughan, Ph.D., C.P.C.U.

In October, 1978, the Federal Reserve Board released a paper entitled "A Study of Tie-ins Between the Granting of Credit and Sales of Insurance by Bank Holding Companies and Other Lenders" ("Board study"). Prof. Emmett J. Vaughan, Partington Professor of Insurance at the University of Iowa, prepared the attached critical analysis of the Board study. This memorandum summarizes Prof. Vaughan's findings.

The Board's study is seriously flawed in principally four ways.

(i) The ultimate conclusions arrived at in the study are contradicted by the evidence the study reveals.

(ii) The Board study contains numerous instances where statistics are manipulated and test results are mischaracterized.

(iii) The study contains numerous conceptual and methodological errors.

(iv) In preparing the study, the Board staff ignored several prior studies which arrived at conclusions contrary to those reached by the Board.

I. Ultimate Conclusions Are Not Supported by the Evidence

The study concludes that explicit tying between the granting of credit and the sale of credit related insurance is "practically non-existent," and that implicit pressures brought by lenders on borrowers are "neither very strong nor widespread in the industry." At the same time, the study admits that at least one out of six respondents (16.4 per cent), and perhaps as many as one out of four (25.2 per cent), stated that he was required to purchase insurance in conjunction with an extension of credit. The data also shows that 50.9 per cent of borrowers surveyed indicated that insurance was "recommended," "strongly recommended," or "required." This evidence is fundamentally inconsistent with the study's ultimate conclusion that explicit tying is "practically non-existent." (Vaughan, pp. 1-3, 26-27.)

The study also reveals that the Board asked holding companies questions to which only one answer could reasonably be expected. For example, the Board essentially inquired of various bank holding companies whether the procedures under which they sell insurance tend to promote tie-ins. As such, the holding companies were essentially asked to confess to illegal sales practices. Not surprisingly, they failed to do so. As a result, the study concluded that such practices are not "widespread." (Vaughan, p. 37.)

Many of the "hypotheses" the study posits are conceptually flawed. For example, the study assumes that if insurance tie-ins really exist, consumers will resent the insurance product. In actuality, to the extent consumer resentment occurs, it is more likely to be directed toward the lender -- not the insurance. (Vaughan, p. 17.) Also, the study assumes that if consumers are required to purchase insurance, they will perceive the insurance as "unnecessary" or "undesirable." Again, comsumers may not react that way at all. Even though they are coerced, consumers may in fact feel that the insurance itself is a "good thing." (Vaughan, pp. 19-20.) Finally, the study also presumes that, if involuntary tie-ins are widespread, a significant number of borrowers are likely to complain. Once again, that is not necessarily true. The amount the borrower could expect to recover if he proved his complaint would be small. Furthermore, by complaining he would jeopardize his future relationship with the lender. (Vaughan, pp. 20-21.)

IV. Prior Studies are Ignored

The Board study states that there are only three readily available published studies that bear "directly or indirectly on the issue of tie-ins between the granting of credit and the sale of insurance." Not so.

In 1967, at the request of Senator Proxmire, the Federal Reserve Board itself made a survey of the Federal Reserve Banks regarding bank holding company penetration rates in the sale of credit life insurance. Also, in 1974, the Federal Trade Commission released a paper which concluded that tying in the sale of credit insurance is widespread. That study was even provided to the Federal Reserve Board in conjunction with the Board's responsibility to report to Congress on the administration of the Truth in Lending Act.

In 1976, the Board itself recommended to Congress that the Truth in Lending Act be amended to provide for a reasonable cancellation period between an extension of credit and the obligation of a borrower to purchase credit insurance. This recommendation was a direct result of the evidence previously provided by the Federal Trade Commission.

The Federal Reserve Board's
Tying Study: A Critical Analysis

by

Emmett J. Vaughan, Ph.D., C.P.C.U.

Partington Professor of Insurance
and Associate Dean of External Programs,
College of Business Administration,
University of Iowa

[Prepared at the request of the
Independent Insurance Agents of America, Inc.]

February, 1979

I. INTRODUCTION

"A Study of Tie-ins Between the Granting of Credit and Sales of Insurance by Bank Holding Companies and Other Lenders" was prepared by the staff of the Board of Governors of the Federal Reserve System at the request of the Senate Committee on Banking, Housing and Urban Affairs. The purpose of this analysis is to appraise the research methodology used in the study and to evaluate the evidence generated and the conclusions reached by the study.

II. GENERAL APPRAISAL OF THE STUDY

Measured against virtually any standard, the study in almost every respect is a remarkably unprofessional piece of research. At best, it is flawed by conceptual and methodological errors and ends up asserting conclusions which are contradicted by the evidence proffered. At worst, it is a crude attempt to mischaracterize and distort factual evidence in order to provide support for preconceived conclusions.

The study's greatest technical defect is that the conclusions are contradicted by the evidence upon which they are supposedly based. Conceptual and methodological errors are, perhaps, pardonable. Conclusions that directly contradict the factual findings of a study, however, are not. The fundamental flaw in the study is perhaps best illustrated by the following:

> In conclusion, analysis of the survey suggests that explicit tying between the granting of credit and the sale of credit related insurance is practically non-existent and that implicit pressures brought by lenders on borrowers are neither very strong nor widespread in the industry. 1/

The "survey" mentioned in this passage asked borrowers about the lender's recommendation with respect to credit insurance at the time the loan was taken out. In summarizing the answers to this question, the study states:

> . . . .Table 4 shows that 74.8 per cent of the respondents did not get the impression that insurance was required . . . On the other hand, 16.4 per cent of the respondents did indicate that they felt that credit insurance was required.
>
> In addition to those borrowers who felt that insurance was required, another 8.8 per cent of all lender groups indicated that it was "strongly recommended." Considering the two categories, the proportion receiving significant sales pressure was 25.2 per cent. 2/

Reasonable people can, of course, disagree on what constitutes a "significant" number of exploited consumers. However, in view of the fact that it is illegal under both state and federal laws to require the purchase of insurance from a lender or its affiliate as a condition to obtaining a

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1/ Study, page 5.

2/ Study, pages 32, 36.

loan, we believe that most people would agree that one out of six (and certainly one out of four) is a "significant" proportion. At any rate, it is difficult to understand how the authors can reconcile the fact that at least one out of six borrowers was required to purchase the insurance with the conclusion that explicit tying is "practically non-existent."[3/]

Thus, in a certain sense, the study achieves its announced objective; that is, it does show "the extent to which tying between the granting of credit and insurance sales may exist."[4/] Nevertheless, the conclusions reached by the study are, beyond any question, contradicted by the evidence adduced. In that sense, the study fails -- hopelessly.

III. THEORETICAL BASES FOR TYING

A. Introduction

The study begins by outlining the theoretical bases for tying, describing the economic conditions under which tying

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[3/] The manner in which the findings in this part of the study are summarized is typical of the subtle misrepresentations that permeate the study. The study continually refers to the fact that 16.4 per cent of the borrowers "felt" that they were required to purchase the insurance. The question to which the responses were given did not ask about the borrower's "feelings" at the time of the loan, but was an explicit inquiry concerning the lender's recommendation about the purchase of credit insurance. A more accurate statement would have been the "16.4 per cent of the borrowers were told that they were required to purchase the insurance."

[4/] Study, page 7.

can exist, the aims of tying, and the definition of tying to be used in the study. First, the study explains the requirement of monopoly power as a condition for tying:

> A fundamental premise of the theory of tying is that in order for a lender to be able to tie the sale of insurance (the tied good) to the extension of a loan (the tying good) some degree of monopoly power must exist in the credit market. 5/

Having suggested that monopoly power is an essential requirement for tying to exist, the study then almost begrudgingly admits that

> . . .many credit markets in which banking organizations compete tend to have relatively high levels of concentration, small numbers of competitors, and restricted entry. All of which suggests that some degree of monopoly power may exist. 6/

Actually, the question of the monopoly power of banks hardly seems debatable; it is a simple fact upon which most economists agree. Virtually all economic literature takes the position that monopoly power exists in the case of commercial banks. This monopoly power stems from the government granting commercial banks exclusive rights to do a checking account business, and then limiting entry into that business by chartering and other entry restrictions. Because customers do not purchase the single product of checking accounts, but rather a package of traditional banking services, the monopoly power in the demand

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5/ Study, page 1-2.

6/ Study, page 13-14.

deposit market helps to create a monopoly power in the credit market.

For local, short-term commercial loans, there is virtually no alternative to a commercial bank. For almost all other types of loans, an alternative to a bank can be found only by paying a higher price. This means that practically all loan markets are not purely competitive and that banks have some monopoly power in each. Bank credit is the preferred alternative because bank credit terms are usually lower.

B. The Study's Definition of Tying

The study outlines two extremes in the tying process: explicit contractual tying, which is illegal under the Sherman and Clayton Acts and Section 106 of the Bank Holding Company Act, and purely voluntary tying. In between the extremes, the study notes, there is a wide range of tying. In posing its definition of tying, the study states:

> Whenever there exists a degree of implicit pressure, the joint purchase is no longer purely voluntary since the consumer's decision is influenced or constrained to some extent by the presence of market power in the tying market. *For the purpose of this study, all joint purchases made in response to such pressures are defined as involuntary tie-ins*. 7/

7/ Study, page 11 (Emphasis in original).

Although it suggests that tying will be defined as joint purchases resulting from any degree of implicit pressure, the study itself in actuality takes a much narrower view of tying, virtually restricting it to a pure anti-trust standard. There is no attempt to correlate the various degrees of tying discussed with the Board's regulatory responsibilities under Section 4(c)(8) of the Bank Holding Company Act. The dangers posed by the "tying effect," are not even mentioned. The delicate position of a borrower vis-a-vis the lender, which can blur the distinction between overt explicit attempts to tie and subtle pressures which have the same result, is also ignored.

Banks enjoy a significant element of power vis-a-vis borrowers, because the borrowing relationship tends to be a continuing one, with little or no opportunity for most borrowers to shop around. The fact that credit must sometimes be rationed, and that under such circumstances the "better" customers of the bank will receive preference, tends to heighten this power.

A bank officer may merely "suggest" or "recommend" that the loan applicant consider purchasing life or disability insurance from the bank. This, it is suggested, would be a "convenient" way to reinforce the loan application. Quite naturally, the loan applicant may consider this "suggestion" to be a requirement that must be met to obtain the loan. Thus, customers perceive the implicit threat of deprivation of a needed banking service and submit to the recommendation to purchase the insurance.

Many authorities consider the various gradations of "voluntary tying" and the "tying-effect" that may accompany the extensions of credit to be as important in their economic effect as involuntary tying.[8] Certainly, they would seem to fall within the scope of the Board's regulatory responsibilities in connection with Section (4)(c)(8) of the Bank Holding Company Act. The fact that the distinction between overt involuntary tying and "voluntary" tying can become blurred when extensions of credit are involved makes the study's neglect of this area an unfortunate omission.

C. Aims of Tying

After outlining the economic conditions that are requisite to tying, the study briefly outlines the reasons a firm may engage in tying:

> The aim of tying arrangements may be (1) to evade price ceilings (especially wartime controls); (2) to make sales that could not otherwise be made; (3) to improve the firm's position in another market; (4) to protect

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[8] For example, see the comments of Assistant Attorney General Richard McLaren during the 1970 hearings on the Bank Holding Company Act amendments. (Hearings on Bank Holding Company Amendments before the Senate Committee on Banking and Currency, 91st Congress, 1st session, 1969).

> the goodwill or reputation of a firm; (5) to achieve economies in joint distribution. 9/

Having established the aims of tying arrangements, the study then drops the matter altogether, making no attempt to show the ways in which these aims have special application in the case of lending and credit. For example, a better example of the price ceilings the seller may attempt to evade might include the usury laws of many states. Where limits are imposed on the interest rate, during periods of tight money lenders cannot raise prices to the point where supply and demand meet. Instead, they "ration" the scarce and essential commodity of credit. This process produces unexercised monopoly power which must either be transferred to some other market or abandoned. Transfer of this power to the insurance market would permit lenders to make sales that might otherwise not be able to be made.

IV. PREVIOUS STUDIES

Major public attention on the subject of credit life and credit disability insurance dates from 1953, when a U.S. Senate Subcommittee on Antitrust and Monopoly first reported on tie-in sales of credit insurance and expressed concern over

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9/ Study, page 8.

abuses in the consumer credit insurance field.[10/] During the twenty-five years since those hearings, numerous legislative and regulatory hearings and investigations have generated reams of material on this subject. Nevertheless, the study states that there are only three readily available published studies that bear "directly or indirectly on the issues of tie-ins between the granting or credit and the sale of insurance." The three studies cited are a National Association of Insurance Commissioners study, the "Huber study," and the "Ohio study."

The NAIC study surveyed state insurance commissioners requesting information on complaints filed by consumers alleging coercion and found that few such complaints are filed. As is noted later, there are numerous reasons that complaints may not be filed, even when tying exists. The Huber study focused on consumer attitudes toward the sale of credit insurance by retailers, and specifically excluded any consideration of lending institutions. Finally, the Ohio study was an extensive consumer attitude survey focusing on consumer reaction to credit life and credit disability insurance. Many of

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[10/] The National Association of Insurance Commissioners had been working on the problem of abuses in this area from an earlier date. The NAIC Credit Life and Credit Accident and Health Insurance Subcommittee conducted an indepth study of the field of consumer credit insurance during the period from 1948 to 1953. The findings of the Subcommittee painted a sordid picture of abuses and debtor exploitation and dictated a need for closer supervision.

the conclusions of the Ohio study parallel those of the current study.[11]

The Board chose to ignore several studies that "bear directly or indirectly" on the issue of tie-in of which it was most certainly aware. For example, in 1967, at the request of Senator Proxmire, the Federal Reserve Board itself conducted a survey of the Federal Reserve Banks. Although the information from this survey is dated, it indicated penetration rates of 90 per cent or more in the sale of credit life insurance.[12] Responses from a number of Federal Reserve Banks expressed concern that abuses were a definite possibility. Yet the current study makes no mention of this earlier study or its results.

The current study also makes no mention of the report transmitted from the Secretary of the Federal Trade Commission to Governor Jeffery M. Bucher of the Federal Reserve Board in November of 1974, in connection with the "1974 Annual Report to Congress on the Truth in Lending Act."

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[11] The research for the Ohio study was supported by grants from the National Finance Association, the American Bankers Association, and the Consumer Credit Association (an association of insurers specializing in the sale of credit life and credit health insurance).

[12] Letter from the Federal Reserve Bank of San Francisco to the Federal Reserve Board. This letter provides a portion of the Board's 1969 credit life study. See Hearings on Consumer Credit Insurance before the Subcommittee of Financial Institutions of the Committee of Banking and Currency, U.S. Senate, 91st Congress, 1st session, 160-164 (1969).

This report focuses on the inadequacies of existing regulations in guaranteeing voluntary election on the part of borrowers in purchasing credit insurance:

> The problems we have encountered in the credit insurance area appear to be in no way alleviated by the present form of Regulation Z. That is, the present provisions of Section 226.4(a)(5) of Regulation Z do not ensure the voluntary election of credit insurance since those creditors who wish to evade the intent of this section may do so by making disclosures which are in ostensible compliance with the Regulation, while orally informing or indicating to the consumer that the insurance is required. 13/

In spite of the fact that its material included a staff report and the letter of transmittal made specific reference to problems the FTC had encountered in connection with tie-ins, the authors of the Board study chose not to investigate as a part of their research the nature and extent of these problems. It is significant that this material was sent to the Federal Reserve Board in connection with the Board's statutory obligation to provide Congress with an annual report on the administration of the Truth in Lending Act. As such, it is an official document which is directly relevant to the

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13/ Letter from Charles A. Tobin, Secretary of the Federal Trade Commission accompanying the FTC 1974 Annual Report to the Federal Reserve Board for the purpose of preparing the Board's Annual Report to Congress. Page 6.

subject matter of the Board's tying study and yet it was completely ignored by the study.

The failure of the study to go into these matters is made all the more peculiar (and perhaps revealing) by the actions of the Board itself. Specifically, in 1976, as a result of repeated expressions of concern by the FTC that Regulation Z was not an effective means of assuring that consumer decisions to purchase credit insurance were in fact voluntary, the Federal Reserve Board, in it annual report, recommended to Congress that the Truth in Lending Act be amended to provide a reasonable cancellation period before credit insurance can be classified as voluntary.[14/]

The study also makes no mention of the issuance of new regulations by the Comptroller of Currency in September of 1977 on the disposition of credit life insurance income of banks.[15/] These regulations were issued on the premise that many of the existing compensation arrangements in banks tended to increase the chances of illegal tie-ins. In view of the fact that the current study examined the question of compensation for insurance sales and its relationship to tie-ins, it is interesting that no mention was made of the Comptroller's

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[14/] Board of Governors of the Federal Reserve System, 62nd Annual Report, 277-78 (1976).

[15/] Federal Register, Vol. 42, No. 185, p. 48524 (September 23, 1977).

regulations. The authors of the current study apparently made no attempt to determine what conditions led to the concern of the Comptroller of Currency that prompted the new regulations.

In view of the fact that the methodology of the current study consists of a survey of consumers and another of bank holding companies, the omission of these sources should have little practical effect on the outcome of the study. Nevertheless, two things are significant: (i) that the study failed to mention the existence of several important surveys bearing directly on the subject matter of the Board's inquiry; and (ii) that much of the material in the studies that the authors chose to ignore is in direct contradiction to the conclusions reached in the Board study.

V. STUDY METHODOLOGY

A. Introduction

The methodology of the study is partially outlined in Section IV, "Study Methodology." In describing the methodology, the text explains that the approach adopted attempts to focus on both the demand side and the supply side of the credit transaction, through a survey of consumer attitudes and a separate survey of bank holding companies. The hypotheses are set forth in the following passage:

> The general discussion of tying contained in Section III suggests that if involuntary tying is a widespread practice it would be reflected in consumer experience with and attitudes toward credit related insurance. The perceived pressures to tie would be greater and would generate widespread consumer resentment. A high proportion of borrowers would be observed to have purchased the insurance; at the same time they would view it as an unnecessary, undesirable, and expensive service. Assuming that widespread tying existed, it would also be expected that a significant number of borrowers who felt coerced would file formal complaints. At the same time, holding company procedures for selling insurance and granting credit would be structured in such a way to facilitate tying. . . .
>
> Having detailed the basic hypotheses of the study, the remaining section presents and analyzes the results of the survey of borrowers and bank holding companies. 16/

The passage cited above contains four separate hypotheses. For the purpose of clarity, it is helpful to restate these hypotheses separately:

(1) If involuntary tying is a widespread practice, it will be reflected in consumer experience with and attitudes toward credit related insurance; the perceived pressures to tie will be great and will generate widespread consumer resentment.

(2) If involuntary tying is a widespread practice, a high proportion of consumers will be observed to have purchased the insurance and at the same time will view it as unnecessary, undesirable, and expensive.

16/ Study, pages 27, 28.

(3) If involuntary tying is a widespread practice, a significant number of borrowers who feel coerced will file formal complaints.

(4) If involuntary tying is a widespread practice, holding company procedures for selling insurance and granting credit will be structured in a way to facilitate tying.

Although the study here refers to the statements as "hypotheses," in actual fact they are treated as assumptions rather than hypotheses. Individuals familiar with standard research techniques and the testing of hypotheses will immediately recognize the methodological error here, and will reject any conclusions concerning the existence or extent of tying that the study may reach as being unsupported by the testing of these hypotheses. However, the manner in which the hypotheses are magically converted into assumptions may mislead the casual reader and thereby give credence to the conclusions where none is merited. For this reason, it is helpful to examine these "hypotheses" more closely, and to explain the distinction between their interpretation as hypotheses and as assumptions.

A hypothesis is a tentative assumption that is to be tested. If the statements suggested in the study are intended as hypotheses to be tested and proven to be true or not true, then the conclusions of the study cannot go beyond the implications of the hypotheses themselves. Certainly, the hypotheses stated in the study do not measure what the study implies that they measure. Consider, for example, the following "hypothesis" of the study:

> If involuntary tying is a widespread practice, a significant number of borrowers who feel coerced will file formal complaints.

A properly designed research model which tested and rejected this hypothesis would not, as the study implies, indicate anything about whether or not tying is taking place. It would merely establish what most informed observers already know -- that if involuntary tying is a widespread practice, it is not evidenced by significant numbers of borrowers filing formal complaints.

B. Validity of the Assumptions

Because the conclusions of the study are predicated on the assumptions embodied in the statements that the study labels as "hypotheses," the validity of these assumptions must be examined before the conclusions arising out of those assumptions may be accepted. We will examine each of the four assumptions individually.

1. First Assumption: If involuntary tying is a widespread practice, it will be reflected in consumer experience with and attitudes toward credit related insurance; the perceived pressures to tie will be great and will generate consumer resentment.

This assumption is partly valid and partly invalid. First, it seems reasonable that widespread tying will be reflected in consumer experience with credit related insurance. However, there does not seem to be any reason to conclude that pressures to tie will be reflected in the consumer's attitude toward the insurance. Similarly, it seems likely that the perceived pressures to tie would be great, but it does not necessarily follow that this will generate consumer resentment, or that the resentment to the extent that it developed, would be directed toward the product.

The extent to which a tie-in between the extension of credit and the sale of insurance will generate consumer resentment will be influenced by the relative intensity of the borrower's desire for the loan and the cost of the involuntary insurance. Where the cost of the insurance is low and the desire for the loan is great, the marginal disutility of the coercion may be insufficient to generate resentment.

In addition, to the extent that tying does generate resentment on the part of the borrower, it seems more reasonable to assume that this resentment would be directed toward the lender, not toward the product. Unfortunately, nowhere does the study attempt to measure the reaction or the attitudes of borrowers toward the lenders.

For these reasons, the validity of the first assumption is highly questionable. It cannot be granted, and conclusions based on its validity cannot be accepted as having been demonstrated.

2. Second Assumption: If involuntary tying is a widespread practice, a high proportion of consumers will be observed to have purchased the insurance and at the same time will view it as unnecessary, undesirable, and expensive.

Again, this assumption appears to be partly valid and partly invalid. First, the assumption that if involuntary tying is a widespread practice, a high proportion of consumers will be observed to have purchased the insurance is valid with reservations. What constitutes a "high proportion of consumers" will -- for various reasons -- differ with the type of insurance. Unfortunately, nowhere does the study define a "high" or "low" penetration rate. One would assume that a scientifically conducted study would have defined the levels of significance before attempting the measurement. To gather data, measure it, and then define the level that is significant on the basis of the findings is not only a faulty research technique, it is intellectually dishonest. Nevertheless, this flaw is of little importance in this study since, as noted later, the penetration rates quoted in the study are highly erroneous as a result of a serious error in methodology.

The assumption that if involuntary tying is widespread a high proportion of consumers will be observed to have purchased the insurance "and at the same time will view it as unnecessary, undesirable, and expensive" must, of course, be rejected as invalid. As noted above, there is no reason to believe that involuntary tying would generate resentment toward the product. To the extent that pressures to tie the sale of one product to another generates resentment, it is logical to assume that the resentment would be directed toward the seller, not toward the product. An individual who is coerced in the purchase of any product may nevertheless feel that the product itself is "good." In the case of credit life insurance, for example, the consumer may feel that it is a "good thing" for the unpaid balance of a debt to be extinguished by the insurance in the event of his or her death.

The assumption that consumers who have been coerced will feel that the product is expensive, is invalid and must be rejected for several reasons. "Expensive" is a relative concept. To the consumer, it may mean "expensive" in terms of the cost of the loan, the amount of the loan protected or "expensive" in terms of the alternative sources of protection. For example, the cost of credit life insurance is small in relation to the other costs of the loan. An individual borrowing say, $6,000 for an automobile might pay $700 or $800 in interest charges. The $36 that might be charged for the credit life insurance is small when compared with the interest charge. Nevertheless, that $36 might be quite high in relationship to what the borrower would pay for similar protection from a different source. Suffice it to that nowhere in the study is the term "expensive" defined or explained. Clearly, credit life and credit disability will be "inexpensive" when compared with the cost of the credit itself. 17/

3. Third Assumption: If involuntary tying is a widespread practice, a significant number of borrowers who feel coerced will file formal complaints.

This assumption is invalid for several reasons. First and most important, the borrower has little to gain by filing a complaint. In most instances, the marginal cost of the insurance will be moderate. The borrower may simply consider the cost of the involuntary insurance a part of the

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17/ In the case of property and liability insurance, the cost of the insurance from a bank affiliated agency will very likely be the same as the cost of that insurance from a non-affiliated agency. Since bank agencies selling property and liability coverages represent the same types of companies as non-bank agencies, there is no reason that the consumer would necessarily feel that the cost is more "expensive" from the bank agency than from its nonaffiliated competitors.

price of the loan. Furthermore, the damages a coerced borrower might be able to obtain are not likely to make the matter worth pursuing. In addition, any borrower who may feel coerced will be acutely aware that he will probably be required to borrow money in the future. Accordingly, he will be reluctant to jeopardize his attractiveness to lenders by filing a complaint against one of them.

4. Fourth Assumption: If involuntary tying is a widespread practice, holding company procedures for selling insurance and granting credit will be structured in a way to facilitate tying.

This assumption is unquestionably valid, and it may be granted tie-in sales will be greater when the procedures for selling insurance are structured in a way that facilitates the tying.

VI. PENETRATION RATES

One of the basic premises of the study is that the existence of tying, either explicit or involuntary, will be manifested in a high proportion of joint purchases.[18] This premise is restated in the hypothesis:

> If involuntary tying is a widespread practice, a high proportion of borrowers will be observed to have purchased the insurance.

In an attempt to measure the proportion of joint purchases, the Federal Reserve Board researchers interviewed 2,563 people.

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[18] Study, page 2.

Of these, something in the neighborhood of 1,100 reported that they had purchased credit insurance. Although it is impossible to determine from the report the number of usable responses generated by the interview process, [19] it is of little matter, since the methodology is badly flawed and the statistics generated are almost meaningless.

Information was generated on the proportion of all borrowers that indicated they had purchased credit insurance in connection with the extension of credit. Borrowers included those dealing with commercial banks, finance companies and credit unions. The results are summarized in the study as follows:

> Table 2 shows the distribution of respondents to the Federal Reserve's special survey of consumer borrowers who had an outstanding closed end credit balance at banks, finance companies, retailers, or credit unions, where the original balance was at least $200. Overall, 62.2 per cent of borrowers indicated that they had credit insurance. [20]

This 62.2 per cent is referred to as a "penetration rate," and the reader is informed that ". . . the proportions are not so high as to be suggestive of the possibility of widespread, explicitly coercive tying."[21] Thus, while the study concludes that its "62.2 per cent penetration rate" is not significant, nowhere do the authors indicate a penetration level that would have been considered significant. Standard research methodology generally requires stipulating a level of significance prior to testing the data. If such a level of significance was established prior to testing in the current study, we are not told what it was.

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[19] The data are unclear on the sample response. The study states that 2,563 individuals were interviewed and that the overall response rate was 75.5 per cent, this would indicate 1,935 interviewees. As noted later in this section, the study asserts that the penetration rate in the sale of credit insurance was 62.2 per cent, which would be about 1,200 purchasers of insurance. However, Table 2 indicates 1,099 borrowers who purchased credit insurance, while Table 4 indicates 1,163. The discrepancies are not explained. See pages 30, 33, and 82 of the study.

[20] Study, page 29.

Furthermore, the penetration rate arrived at in the study is grossly distorted. In this segment of the study, the researchers committed the surprisingly serious error of confusing two populations. In the first place, not all lenders sell credit insurance, so it naturally follows that there are two groups of consumers being interviewed: those who borrowed from lenders that sell credit insurance and those who borrowed from lenders that do not. Since the "62.2 per cent penetration rate" is based on the percentage of both groups who purchased insurance, it is preposterous to suggest this as a penetration rate. To the extent that the sample of interviewees included borrowers from institutions that do not offer credit insurance, the 62.2 per cent measure significantly understates the true penetration rate. For example, if as many as 35% of the lending institutions involved did not offer credit insurance, the penetration rates for lenders that do sell the coverage is an incredible 96 per cent, a figure more in line with that generated by other studies that were ignored.[22/]

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[21] Study, page 32.

The 62.2 per cent figure understates the penetration rate for other reasons as well. For example, the "Ohio study," which is extensively cited in the current study, found that 9.85 per cent of borrowers surveyed did not know that they were obtaining credit life insurance when their loan was made.[23/] Because the current research design depended on the consumer to report whether or not he had credit insurance, it seems likely that there is an understatement in terms of the number of borrowers who had purchased credit life insurance but did not know that they had done so.[24/]

[22/] For example, see the 1974 Report of the Federal Trade Commission to the Board of Governors of the Federal Reserve System, which reports penetration rates of from 81 percent to 98 per cent for a sample of national finance companies.

[23/] Charles L. Hubbard (ed.), Consumer Credit Life and Disability Insurance, A Study by the College of Business Administration of Ohio University (Athens, Ohio: College of Business Administration of Ohio University, 1973), p. 77.

[24/] One of the abuses uncovered by the NAIC subcommittee in its study of consumer credit insurance was the failure of lenders to inform the insured debtors that coverage was in force. The net result was that many survivors did not know that insurance existed, and not knowing did not press for payment in the event of the borrower's death, continuing instead to make the required payments. As late as 1973 nearly one out of ten borrowers did not realize they were purchasing the insurance at the time of the loan.

Still another omission that results in an understatement of the penetration rate is in ignoring those borrowers who are not eligible for credit insurance. The "Ohio study" interviewed those consumers who did not purchase credit insurance, in order to determine their reasons for not doing so. It found that 4.5 per cent of the borrowers had not purchased the coverage because they were over 65 and were therefore ineligible for the coverage. [25/] Although the Ohio study did not do so, it seems reasonable to exclude these borrowers in computing penetration rates. However, the current study did not even attempt to measure this segment of the market.

Although the suggested 62.2 per cent "penetration rate" is clearly a distortion which understates the true rate, it becomes significant in light of the following observation:

> . . .the frequency with which consumers purchased credit insurance is high enough, particularly since 97.5 per cent indicated that the purchase had been through the creditor, to be consistent with the hypothesis that some tying may be taking place and warrant further study. [26/]

Since it is obvious that the true penetration rate is significantly higher than the 62.2 per cent suggested as being "high enough . . . to be consistent with the hypothesis that some tying may be taking place . . .," there is a temptation to rest the case.

[25/] Hubbard, op. cit, page 87.

[26/] Study, page 29.

VII. EXTENT OF DIRECT PRESSURE ON BORROWERS

The consumer survey also sought to determine the extent of direct pressure exerted on borrowers to purchase insurance at the time of a loan. Summarizing the results of this portion of the research, the study states:

> The absence of widespread explicit coercion is further supported by the responses to questions directed toward eliciting information on perceived lender pressure in insurance sales. Table 4 shows that 74.8 per cent of the respondents did not get the impression that insurance was required. From Table 5, the percentage ranged from a low of 65.2 per cent for finance companies to a high of 84.5 per cent for retailers; banks were 76.5 per cent. On the other hand, 16.4 per cent of the respondents did indicate that they felt that the insurance was required.
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> In addition to those borrowers who felt that insurance was required, another 8.8 per cent at all lender groups indicated that it was "strongly recommended." Considering the two categories, the proportion perceiving significant sales pressure was 25.2 per cent. 27/

We have already noted the inconsistency between this evidence and the conclusions of the study. In the face of the above findings, it is difficult to understand the study's final conclusion that there is little evidence of involuntary tying or coercion -- let alone the assertion that such practices are "almost non-existent."

27/ Study, pages 32, 36.

Recognizing the delicate position of the borrower vis-a-vis the lender, and the subtle differences between involuntary tying and "voluntary tying" in this area, the possibility of coercion seems even greater. The borrowers who stated that the insurance was "recommended," "strongly recommended," and "required," totaled 50.9 per cent of the respondents.[28/]

VIII. ANALYSIS OF CONSUMER ATTITUDES TOWARD CREDIT INSURANCE

The consumer survey conducted by the Federal Reserve Board attempted to measure the attitudes of borrowers toward credit life and credit disability insurance, on the premise that if widespread tying exists, it would be evidenced by a low opinion of the product tied and a feeling on the part of consumers that the product is expensive. We have previously rejected these assumptions as unproven and probably invalid. Nevertheless, it is still interesting to note the results of the survey and the manner in which the findings are presented.

A. Consumer Opinions of "Goodness" or "Badness" of Credit Insurance

In summarizing the findings concerning consumer attitudes on the "goodness" or "badness" of credit related insurance,

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[28/] Study, page 33.

the study states:

> First, respondents were asked whether or not they considered credit insurance "a good thing." A wide range of responses were permitted, including not only "good" and "bad" but gradations in between, such as "good with qualifications," "neither good nor bad," and "bad with qualifications." Table 6 shows that a large majority (73.1%) of credit users regarded credit insurance as "good" without qualification. In contrast, only a small minority (5.2%) responded that credit insurance was "bad." If line categories 1 and 2 in Table 6 are combined and the categories 3 and 6 are excluded as having no opinion, then 94.2% of respondents replied they thought credit insurance was a good thing, the large majority without qualifications. 29/

The process of lumping "good" and "good with qualifications" together as good does not reflect the responses of the respondents. "Good with qualifications" means "good with qualifications," it does not mean "good." Furthermore, excluding the responses "neither good nor bad," and "do not know or not ascertained" to imply a higher proportion responding "good" does not alter the number responding "good" either. What is more, it is the crudest form of data manipulation which is counterproductive from a scientific viewpoint and calls into question the objectivity of the study's authors.

Table 7, which purports to indicate the attitudes of selected sub-groups of borrowers is misleading, and suggests a very high percentage of respondents indicating that credit insurance is "a good thing." Although the table or the text

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29/ Study, pages 35, 37.

does not explain so, the figures in this table were apparently constructed on the basis of the previously noted assumptions (that is, that "good with reservations" means the same thing as "good," and that those who had no opinion or those who felt that insurance was "neither good nor bad" should be excluded in computing the percentage of consumers who felt that the coverage was "good"). The manner in which the data is misrepresented is symptomatic of the flaws and self-serving nature of the entire study.

Even without the distortions created by the manipulation of the data, one could reasonably agree that a significant percentage of consumers indicated a favorable attitude toward credit life insurance. As noted earlier, however, the data on the attitude of the purchasers toward the product was generated only because the survey asked the wrong question. There is no reason to assume that consumer resentment, to the extent it is created, would be direct toward the product. More naturally, it would be directed toward the lender.

B. Consumer Attitude Toward Cost

The survey also attempted to measure consumer attitude toward the cost of credit life insurance, on the premise that widespread tying would result in a feeling on the part of consumers that credit related insurance is "expensive."

The results on this area of investigation are stated as follows:

> . . .Table 13 shows that the vast majority of consumer debtors with credit insurance do not consider the service expensive. The results are expanded in Table 14 to provide proportions of various subgroups of credit users finding credit insurance expensive. The proportion of those finding credit insurance expensive ranges from a low of 11.8 per cent to a high of 20.9 per cent. 30/

We have already discussed the implications of these responses. Since "expensive" is a relative concept and since the relativity is nowhere explored in the study, the answers provide little in the way of useful information. To the extent that a properly structured test of the study's assumption concerning consumer attitudes toward the cost of credit related insurance might result in a rejection of a hypothesis, it would merely indicate that tying does not result in a perceivable consumer attitude on the cost of the insurance.

IX. CONSUMER COMPLAINTS

Following the premise that tie-in sales would result in resentment on the part of the consumer, and that this resentment would be evidenced by complaints to regulatory

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30/ Study, page 43.

authorities,[31] the Federal Reserve Board made a limited and selective search for such complaints:

> In the belief that buyer resentment would be strongest and most likely to generate complaints in those cases involving explicit formal tying, the complaint files at the Federal Reserve System were canvassed. No complaints had been filed since 1970 alleging violation of Section 106 of the Bank Holding Company Act either by businesses or consumers. This tends to support the findings of the 1970 study by the National Association of Insurance Commissioners in which the incidence of this type of alleged violation was also very low. 32/

Although the number of formal complaints cannot, for various reasons, indicate the extent of illegal tying, it is important to note that the study ignored the existence of complaints to other regulatory agencies of which the Board was aware. Following the pattern used throughout the study of selective use of evidence, the study fails to mention the complaint filed by consumers with the Federal Trade Commission, which were outlined in the 1974 annual report of the Commission to the Federal Reserve Board. The FTC study

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31/ As a hypothesis, the statement that tie-in sales will result in resentment and that this resentment will generate a significant number of complaints, would probably be rejected by a properly designed investigation. This would merely indicate that if widespread tying exists, it is not manifested by numerous formal complaints. However, the current study did not test this hypothesis, but merely treated it as an assumption.

32/ Study, page 32.

included as a part of this report made the following observations:

> . . .Much of the material on which this memorandum is based has been drawn from material gathered in the course of the staff's current investigation of credit insurance sales practices of direct loan finance companies . . .
>
> . . .the consumer complaint, attached with accompanying correspondence as Appendix 1 of this memorandum is typical of the type of credit insurance complaint the Division receives from customers. 33/

The FTC report then outlines in detail a situation in which one borrower (an attorney) filed a complaint first with the lender and then with a bank regulatory agency, alleging explicit formal coercion to purchase insurance in connection with a loan. After being informed in writing of his freedom to reject the credit insurance, he was informed orally that the insurance was required. The Commission concluded:

> . . .the present provisions of Section 226.4(a)(5) of Regulation Z do not ensure the voluntary election of credit insurance since those creditors who wish to evade the intent of this section may do so by making disclosures that are in ostensible compliance with the Regulation, while orally informing or indicating to the consumer that the insurance is required. 34/

33/ Federal Trade Commission, 1974 Report to the Board of Governors of the Federal Reserve System, Attachment A, Statement of the Staff of the Division of Special Statutes on Credit Insurance Sales Practices and Section 106(b) of the Truth in Lending Act, page 1.

34/ Letter from Charles A. Tobin, Secretary, Federal Trade Commission, to Governor Jeffrey M. Bucher, Board of Governors of the Federal Reserve System in reference to the 1974 Annual Report to Congress on the Truth in Lending Act, page 6.

It should be emphasized that the Commission stated that the complaint was typical of the type of complaints that the Commission receives from consumers. The decision to ignore this critical source is again indicative of the bias in the study and the relatively narrow and selective data base upon which the study is based.

X. SURVEY OF THE BANK HOLDING COMPANIES

A. Introduction

The second portion of the study involved a survey of bank holding companies, to determine if structural conditions reported by these companies are indicative of conditions that imply the existence of tie-in sales of insurance with credit. The survey sampled 53 of the 390 bank holding companies that listed insurance agency activities as an authorized activity as of December 1975. Of the sample chosen, 10 were engaged in the sale of credit life and disability insurance only, leaving 27 institutions engaged in the sale of property and liability insurance and credit life and disability insurance.

The survey asked the bank holding companies to respond to questions in three areas:

1. The authorities under which the banks were engaging in insurance activities.
2. Information on bank holding company organizational structures and practices in originating insurance and insurance referrals in order to detect any patterns which would be suggestive of tying practices.

3. Data was also collected on penetration rates to measure the volume of joint sales in order to identify those areas in which tying might be likely.

Since the first of these fields of inquiry has no relationship to the existence or extent of tying, we will ignore it and focus on the other two.

B. Sales Policies Relating to the Sale of Insurance

The survey requested respondents to report on their sales policies and procedures. Specific questions related to the sequence and timing of insurance sales and the approval of a loan. In addition, information on the compensation of bank holding company employees for insurance sales was also requested.

According to the study, the results of this survey indicated an absence of tying. However, this conclusion, like so many others in the study, is totally unsupported by any of the evidence.

1. Credit Life and Disability Insurance Sales Policies and Procedures

First, with respect to policies and procedures of the bank holding companies engaged in the sale of credit life and credit disability insurance, the study states:

> Patterns of conduct in the sale of credit life and disability insurance are quite similar across all responding institutions. Typically, lending officers or bank executives negotiate the credit transaction and offer the insurance before the monthly payment is determined, but after the credit is approved. . . .The majority

> of respondents advise the customer in writing that credit insurance is not compulsory. 35/

Turning to the subject of compensation in connection with the sale of credit life and credit disability insurance, the study reports:

> With respect to the means of compensation, there is a wide diversity among these firms. The larger organizations, as a general rule, operate only on straight salary while the smaller organizations prefer some combination of salary and a variable compensation such as bonuses, commission, or fees. 36/

2. Property and Liability Insurance Policies and Procedures

Although the major thrust of the study focuses on credit life and credit disability insurance, the survey of bank holding companies includes bank holding companies authorized and engaged in the sale of property and liability insurance. With respect to these firms, the study reports as follows:

> The organizations which also sell property and casualty insurance tend to show greater variation in their operational mode than those that sell only credit life and disability insurance. Generally, the type of insurance offered is restricted to selected lines, and insurance sales are made by licensed agents who are employees of the various subsidiaries of the holding company. Typically, the licensed agents perform administrative and lending functions in addition to their insurance activities. But in larger organizations, they tend to be full time in the insurance agency function with no other duties. Loan officers generally do ask for details of existing property and casualty coverage on collateral, including the various characteristics of the present policy, in order to

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35/ Study, page 56.

36/ Study, pages 56, 57.

> determine the adequacy of existing coverage and to obtain a means of checking that the lending institution is shown as the loss-payee on the policy. There is near unanimity that coverage is offered if the existing policy is not adequate, but it is not made mandatory to obtain insurance with the banking organization. Most respondents report that the offer of insurance is made after the loan is approved and prior to the determination of the monthly payment. The pattern of agent compensation tends to be different for small and large organizations. In the former, variable commission is more prevalent, while in the latter straight salary is the rule. [37]

C. Conclusions Relating to Structure and Policies

On the basis of its findings relative to structure and sales policies, the study arrives at the following conclusion:

> The implications from the review of the responses to survey questions on operational policies and conduct in the sale of insurance is that there is no evidence of explicit coercive tying. Moreover, there is no widespread behavior consistent with systematic attempts to pressure customers to involuntarily purchase insurance. The frequency with which the respondents indicated that insurance is offered after the loan is approved and that insurance is optional would not seem indicative of behavior that attempts to induce a tied sale. [38]

The evidence presented in support of this conclusion is not convincing.

For some unexplained reason, the authors of the study chose not to share the responses from the bank holding companies with the reader, other than in general terms. Instead of presenting a complete summary of the responses in this area, a limited selection of individual answers to specific questions is provided as an appendix "to substantiate the generalizations and to provide flavor of the diversity reported." In light of the misrepresentations placed on other data throughout the study, one would have preferred an exhibit of the actual responses to the survey, rather than the generalizations that are provided.

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[37] Study, pages 57, 58.

[38] Study, page 59.

1. Conclusions Relating to Sales Policies

It is not particularly surprising that the survey did not reveal sales policies or procedures conducive to overt tying, since the research technique used was to ask the bank holding companies to indicate if such policies or procedures exist. In order to put this methodology in its proper perspective, it is important to recall that overt tying is illegal under both Section 106 of the Bank Holding Company Act and under the laws of most states. In essence, the survey asked the bank holding companies to confess to illegal practices, and then concluded that such practices are not widespread because few respondents admitted to them. One might presume that a survey of bank tellers inquiring as to the extent they were embezzling would provide evidence that there are currently no embezzlers in the banking system.

2. Conclusions Relating to Structure

The conclusion that the structure of bank holding company insurance and loan transactions do not indicate a structure conducive to coercion is difficult to understand. Although, as we have noted, no aggregate data on the relationships are presented, many of the answers provided in Appendix 1 seem to indicate that even in the case of property and liability insurance the lending officer is also the insurance agent. The opportunities for abuse in these circumstances are self-evident, but the study ignores the implications of these findings.

D. Conclusions with Respect to Compensation Arrangements

The conclusions concerning the system of compensation used by bank holding companies are as unsupported and biased as the rest of the study. For example, while the conclusion states that the prevalence of fixed compensation of insurance agents in large bank holding companies (as opposed to commission) lessens the likelihood of tying, it ignores the converse position -- that the compensation of those insurance agents who are on a commission basis increases the likelihood of coercion. Furthermore, other than the generalizations about "large bank holding companies," and smaller firms being different, no information is provided on the prevalence of commission arrangements as opposed to fixed compensation.

Although the study concludes that the compensation systems of the bank holding companies do not encourage tie-in sales, in September of 1977 the Comptroller of the Currency issued new regulations concerning the disposition of credit life income of national banks, on the premise that many of the compensation arrangements tended to increase the chance of illegal tie-ins. The announcement of the new regulations explained:

> An additional basis on which the Comptroller promulgates this regulation is his concern that the use of credit life insurance commissions as an incentive to encourage loan officers to sell credit life insurance tends to increase the chances of an illegal tie-in between the sale of credit life insurance and the granting of credit. [39]

At the time the new regulations were proposed, over 200 comments were received, raising numerous objections.

As a final note on the relationship of compensation system and the proclivity to tie, it should be noted that even the assumption that a fixed salary arrangement lessens the likelihood of tying is debatable. Presumably, even under a "fixed salary" arrangement, compensation will be based on employee performance. While the nexus is less direct, a fixed salary system does not necessarily lessen the prospect of tying. [40]

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[39] Federal Register, Vol. 42, No. 185, p. 48524 (September 1977).

[40] For example, see Appendix 2 of the 1974 Report of the Federal Trade Commission to the Board of Governors of the Federal Reserve System for an indication of the manner in which the sale of credit related insurance can be considered in the performance appraisal of employees.

E. Penetration Rates

The "penetration rates" computed in the consumer survey have been shown to be grossly inaccurate. The study also attempted to derive penetration rates in its survey of the bank holding companies:

> As mentioned previously, high sales penetration rates may be key indicators of the potential existence of tying. Therefore, the bank holding companies surveyed were requested to supply penetration rates, both by type of loan transaction and by type of subsidiary originating the loan. Numerous respondents failed to supply this statistical information on the grounds that their records are kept in a way which would not be suitable to supply this information. [41]

Although it is unfortunate that the respondents failed to supply the statistical information requested, it is even more unfortunate that the information that was supplied was not presented in a clear and open fashion. There is no indication in the study of the number of those surveyed that did provide usable information, nor is the data received presented in a meaningful or comprehensible fashion. One can speculate on the basis of the other flaws in this study why the authors chose to subdivide the limited but unknown number of responses received from a total of 37 respondents into four subdivisions and then report the median values. The technique obscures the information beyond comprehension. Clearly, it would have taken little more time or space to report the limited number of values that were received. One can draw conclusions concerning this decision on the basis of the other methodological errors and conceptual flaws in the study, as well as the blatantly biased manner in which other information is presented.

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[41] Study, page 59.

In spite of the statistical deficiencies, the study has no reservations about making conclusions on the basis of the property and liability penetration rates:

> The reported penetration rates of credit related property and casualty insurance appear, in general, to be significantly lower than would have been expected if tying were a widespread practice in the industry. 42/

As in the case of the other conclusions in the study, there is nothing in the evidence to support this conclusion. Nowhere does the study define what a significant level of penetration for property and liability insurance would be. As was the case with respect to the previously discussed credit life and credit disability "penetration rates," the study merely presents the rates derived from the research, along with the unsupported assertion that the level is not significant.

XI. SUMMARY AND CONCLUSIONS

The fact that the Board of Governors of the Federal Reserve System would lend its name and its prestige to this study is both astonishing and disappointing. Perhaps more than any agency of the federal government, the Federal Reserve

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42/ Study, page 4.

Board knows how to construct viable economic models and perform valid research. Nevertheless, measured against any standard of scholarly undertaking, this study is unprofessional. It combines conceptual and methodological errors with misinterpretations of evidence and misrepresentations of fact. What is more, it contains statistical shell games of the crudest sort.

The study's one salient finding, however, remains unobscured -- namely, that at least one out of every six (and perhaps as many as one out of every four) persons surveyed had been required to purchase credit insurance in conjunction with extensions of credit. In the face of this evidence, for the Federal Reserve Board to reach the conclusion that the tying of insurance sales to extensions of credit is "practically non-existent," operates to obscure issues that have direct relevance to the Federal Reserve Board's responsibility under Section 4(c)(8) of the Bank Holding Company Act to assure that bank holding company involvement in nonbanking activities does not cause injury to the public interest.

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APPENDIX I

FEDERAL TRADE COMMISSION
WASHINGTON, D. C. 20580

BUREAU OF
CONSUMER PROTECTION

Honorable William Proxmire
Chairman, Senate Committee on
Banking, Housing, and Urban Affairs
Washington, D. C. 20510

5 FEB 1979

Dear Chairman Proxmire:

Thank you for your letter to Chairman Pertschuk requesting comments on the Federal Reserve Board staff's recent study of coercive practices involved in the sale of credit insurance ("FRB Study"). 1/ Your letter has been referred to me for reply. Please note that the views expressed in this letter are those of the FTC staff.

The FRB study, which is based on a consumer survey and analysis of information voluntarily submitted by creditors, concludes that the explicit tying of credit insurance to extension of credit is practically nonexistent and that implicit pressures are neither strong nor widespread. FRB Study at 5. This conclusion, of course, conflicts with repeated recommendations made by the Federal Trade Commission for increased consumer protections to insure truly voluntary election of credit insurance, with attempts by independent insurance agents to limit the insurance related activities of bank holding companies, 2/ and with efforts by the Comptroller of the Currency to correct credit insurance marketing abuses. 3/

The FTC's past recommendations have been based on our experience with creditors subject to our enforcement jurisdiction. The FRB study, while including some creditors not subject to our jurisdiction, also includes retailers and loan companies which are subject to our jurisdiction. Since the FRB Study's conclusions with respect to our creditors contradict our enforcement experience as well as our earlier 1973 consumer survey, we have analyzed the FRB Study and we believe the following points may help explain the differences in findings and conclusions.

(1) The FRB conclusions with respect to coercion based on voluntarily submitted descriptions of sales practices and penetration rate data 4/ derived from (a) a bank holding company survey and (b) a consumer survey appear unreliable.

(a) The FRB reported lower penetration rates for creditors under our jurisdiction than our enforcement surveys have found. FRB Study at 59-63. Attachment A, for example, reveals penetration rates recently collected from consumer finance ompanies by the FTC staff. These rates, which range in the igh 90's and often approach 100%, are substantially higher than those reported by the FRB Study. Review of the FRB Study ndicates several reasons for these discrepancies. First, the RB included in their study several classes of transactions in which it is generally acknowledged that credit insurance oercion is non-existent. These include commercial loans and ortgage transactions. Our experience has been that the incentive to tie credit insurance to extensions of credit varies ccording to the nature of the credit transaction and that to etermine whether coercive sales practices exist, it is necessary to isolate those classes of transactions which are most susceptible o the practice, i.e., those in which the creditor has the reatest market power or in which other market forces (e.g. low state usury limits or strong cash price competition) may lead creditor to engage in deception to increase its yield on the ransaction. As illustrated by Attachment A, this pattern of unusually high penetration rates appear to vary on a state by tate basis. California, for example has unusually strong nforcement procedures and creditors there have consistently reported lower penetration rates since we began collecting hem in 1973.

Secondly, the FRB study acknowledges that it sought penetraion rate data only on a voluntary basis and that numerous espondents failed to supply the information. We believe that the voluntary nature of the request resulted in an invalid sample ince creditors with low (favorable) penetration rates would eport them and those with high rates would generally not respond. It is unlikely that a creditor would voluntarily provide a regulatory agency with data suggesting a possible law violation. n FTC enforcement surveys of creditors within our jurisdiction all members of the sample are required to respond.

A similar analysis can be made of the FRB Study's conclusion that there is "no evidence" of explicit coercive tying based on descriptions of credit insurance sales policies voluntarily ubmitted by bank holding companies. FRB Study at 59, 61-62. To expect a bank holding company to announce to the FRB that it forces consumers to purchase insurance is as unrealistic s to expect this information to be found in operating instructions. Even so, some organizations were at least candid enough to admit that they "have a policy of trying to sell insurance th every extension of credit." FRB Study at 58.

(b) The FRB Study also based findings of lack of coercion n information contained in a consumer survey separately commissioned by the Board (1977 Consumer Credit Survey, hereinafter "Consumer Credit Survey"). This survey calculates enetration rates and draws conclusions about coercion based n whether the consumers surveyed indicated that they had purchased credit insurance. FRB Study at 29-32 and 35. If the onsumer indicated that they did not have insurance they were reated as not purchasing the insurance. We believe drawn by the FRB Study based on the Consumer Credit survey are invalid since many consumers are charged for "optional" credit insurance without being aware that they have such coverage. For example, a recent consumer study 5/ shows that almost 40% of the retail credit customers surveyed did not know they had credit insurance coverage when they, in fact, were being charged for it. We believe this phenomenon adds great weight to the likelihood of a tie-in between the insurance and the extension of credit. Credit insurance can be sold to consumers without their knowledge or consent; no explicit coercion is required. This phenomenon also raises substantial questions concerning the value of such credit insurance coverage. If consumers are unaware of the coverage they are unlikely to submit claims.

Similarly, in our enforcement survey of 2000 consumers who purchased credit insurance in 1973, almost 12% of the consumers whose contracts contained charges for insurance indicated that they did not know they had the insurance. (Attachment C) 6/ One consumer, for example, responded to our questionnaire by thanking us for telling him he had the insurance. Other consumers, who knew they had credit insurance, responded by asking what credit insurance was. Thus, while we believe the FRB's consumer credit survey is useful in discussing consumer attitudes toward credit insurance, it cannot be used to support findings with respect to the voluntary nature of such insurance.

(2) The FRB Study indicates that no complaints have been filed by consumers alleging tying of credit insurance to their transactions. FRB Study at 2 and 32. If the statement means that no consumers have specifically alleged violations of §106 of the Bank Holding Company Act, it is understandable since we doubt consumers are aware of that Act. If, however, the statement is intended to indicate that no complaints were received by the FRB concerning coercive credit insurance sales practices, we find it particularly distrubing since our 1974 annual report to the Board included copies of a well documented consumer complaint alleging that the consumer was forced to purchase credit insurance in connection with a loan by a bank (Attachment D). This complaint was originally filed with a Federal Reserve Bank.

Subsequently, in 1975, we entered a consent order against Guardian Loan, a wholly owned subsidiary of a bank holding company, alleging coercive credit insurance sales practices in violation of the Truth in Lending Act. 7/ The order in that case resulted in the refund of over $40,000 in unearned credit insurance premiums to the company's customers. 8/ So strong, in fact, was Guardian Loan's compulsion to force credit insurance that when a newspaper reporter called the company while the order was pending final acceptance he was told that he didn't have to take the insurance but: "If you want the loan we [Guardian] recommend insurance". 9/ The sale of this loan company to another bank holding company was later approved by the FRB citing as a benefit to the community proposals to have Guardian offer "additional credit insurance coverage." 10/ The FRB was notified of both the Guardian case and the resulting refunds in our Annual Reports to the Board, as well as other cases against creditors dealing with misrepresentation of the optional nature of credit insurance.

3) The Study's conclusions are based on a premise that tying would produce substantial consumer resentment against credit insurance. FRB Study at 2,3, 27-28. Since the Study found no consumer complaints and the FRB Consumer Credit Survey indicated 73% of the consumers who knew they had insurance thought it was a "good thing", the FRB Study concluded that this was no indication of coercion. We believe the premise underlying this conclusion is invalid. First, as indicated above, we believe the FRB Study's analysis of consumer perceptions is unreliable since the study did not determine how many consumers were charged for the insurance without knowing it. Customers who don't know they have insurance cannot be expected to complain about it. However, it is important to understand that tying of credit insurance to extensions of credit can result in consumer injury even if consumers want the product and believe it is a "good thing". Thus, for example, a Washington Post article in 1975 described the practice of several car dealers of selling more expensive credit insurance than was offered by the manufacturer owned finance companies through which the purchase was financed. 11/ Customers of this company may wish the insurance but they are still overcharged for it. Similarly, a recent Illinois case found that an auto dealer which sold its customers the most expensive forms of credit insurance in place of available cheaper coverage, may have breached its fiduciary duty under state law. 12/ Both of these examples should also be considered in the context of a recent study suggesting that some consumers may be able to save money by buying decreasing term insurance in place of credit insurance. 13/

The fallacy of the FRB Study's premise is most vividly illustrated by the current controversy about overcharges in the annual percentage rate. Recent bank examinations reveal substantial overcharges to consumers through understatement of the Annual Percentage Rate. Yet it is clear that there is even less of a record of "consumer resentment" of these overcharges than can be established for coercive credit insurance sales practices. Since as much as 50% of the credit insurance premium is retained by the creditor, tying of credit insurance to the extension of credit is, in fact, simply a variation of an understatement of the APR. In this respect we recommended that the bank regulatory agencies incorporate in their joint enforcement guidelines procedures for detecting involuntary credit insurance sales; however, these procedures were not adopted. 14/

Finally, the clearest source of complaints concerring tying arrangements would appear to be from those competitors who have been, or are being, excluded from the market by the tie. The FRB Study, however, makes no attempt to analyze the quantity, quality or validity of information available from this important source.

4) Even with its shortcomings the FRB Study still finds that approximately 25% of the consumer surveyed stated that their transactions bore indications of coercion. FRB Study at 36-37. Since the FRB study did not have access to the underlying documentation, the FRB did not draw any conclusions as to whether law violations occurred in these transactions. FRB Study at 36. Because our previous survey was based on the underlying documentation which showed that in each case the creditor characterized insurance as "optional," we are able to show an apparent 25-40% violation rate. Moreover, because in our experience circumstances in which credit insurance is characterized as "required", and therefore included in the finance charge, are very rare, 15/ we believe the FRB study can, despite its limitations, be said to corroborate our findings. We would, however, differ with the conclusion drawn by the FRB Study that this level of coercion is not significant. We believe a 25% violation rate is not only significant but unacceptable.

While we believe the above four points are the most important there are numerous other specific statements made by the FRB Study which are contrary to our enforcement experience. For example, the FRB Study concludes that where credit is rationed (*i.e.*, the demand for credit exceeds supply) consumers "may be induced to tie voluntarily their purchase of insurance to the loan application to enhance their chance of obtaining credit." FRB Study at 14. While the FRB Study concludes that this is a "voluntary" purchase we believe that it is fundamentally involuntary and perceived by the consumer as a condition to obtaining the loan. This perception is tied to the lender's market power and is exactly the type of incipient violation of the antitrust laws that the FTC has attacked in other contexts. 16/ Similarly the FRB Study draws the legal conclusion that it would also be fair to infer from the existing precedents that the practices would have to be quite blatantly coercive for them to be declared illegal." This conclusion contradicts principals established in such court cases as FTC v. Shell, 360 F.2d 470 (5th Cir.) cert denied 385 U.S. 1002 (1967). Both the FTC and the FRB have the power to apply the Shell standard to sales of credit insurance.

I hope that you will find this information responsive to your inquiry and that it will explain the variance in our experience and the FRB Study. My views should not be misconstrued as comments on the merits or the current controversy over whether bank holding companies should be allowed to sell insurance. We have done no analysis of the impact of this arrangement on coercive insurance sales practices. 17/ However, the unexplained conclusions drawn by the FRB Study offer substantial weight to the industry position in the already one sided debate on the issue of credit insurance reform and my remarks are designed to ensure that the study is considered in context.

Sincerely,

Lewis H. Goldfarb
Assistant Director for
Credit Practices

Footnotes

1/ A Study of Tie-ins Between the Granting of Credit and Sales of Insurance by Bank Holding Companies and Other Lenders. (Hereafter "FRB Study").

2/ Alabama Ass'n of Ins. Agents v. Board of Governors, 533 F.2d 224 (5th Cir. 1976).

3/ Disposition of Credit Life Insurance Income, 42 Fed. Reg. 48518 (September 23, 1977).

4/ "Penetration rate" the percentage of all loans included having credit insurance charge.

5/ Coapstick, Consumer Perceptions of Credit Insurance, Proceedings of the 1978 Conference of the American Council on Consumer Interests (Attachment 2).

6/ Our enforcement surveys begin with subpoenas for the contracts, after which consumers whose contracts bear charges for the insurance are contacted.

7/ In the Matter of Guardian Loan, 88 F.T.C. 632 (C-2846, 1976).

8/ This amount represented only unearned premiums at the time resolicitation was made; thus, the actual amount of overcharges would have substantially exceeded that amount.

9/ Washington Star, April 10, 1976, p. E-7.

10/ Federal Reserve Bulletin (October 1976) at 864-66.

11/ Washington Post, Sunday, November 17, 1974, H-1.

12/ Browder v. Hanley Dawson Cadillac, Nos. 77-632-33 (Ill. Ct. of App. May 5, 1978) (Copy attached).

13/ Rubin, Credit Life Insurance and Its Alternatives, 12 Journal of Consumer Affairs, 145 (Summer 1978) (Copy attached.)

14/ Our proposal was modeled on California's successful enforcement program. If the examiner finds evidence of coercion, e.g. high penetration rates, alteration of the signature box with "X" to sign here) he sends out a small number of questionnaires. If the responses indicate that the consumers did not realize the insurance was optional, a larger survey and corrective program may be initiated.

15/ The single largest exception being Federal Credit Unions which provide credit life insurance to their members without separate charge. The credit union's marketing procedure eliminates insurance commission problems and is consistent with our past recommendations for reform.

16/ Texaco v. Federal Trade Commission, 393 U.S. 223 (1968).

17/ The Comptroller of the Currency's staff has completed an economic study tending to show higher credit insurance sales by banks in which credit insurance premiums are diverted to bank directors than for banks which do not.

Attachment A

CREDIT LIFE INSURANCE PENETRATION RATES	Company "A" 1977	April 1978	May 1978	Company "B" 1977	April 1978	May 1978	Company "C" 1977	April 1978	May 1978	Company "D" 1977	Apr-June 1978	Company "E" 1977	Apr.1-May 1978	Company "F" 1977	April 1978	May 1978
Alabama				96.0	96.0	95.0										
Alaska															[illegible]	[illegible]
Arizona	79.9	78.3	83.2	92.0	[illegible]	[illegible]	85.5	[illegible]	86.7			76.8	79.0		[illegible]	[illegible]
Arkansas																
California				90.0	92.0	93.0	74.2	72.0	71.8			65.0	76.7		[illegible]	[illegible]
Colorado	84.2	79.1	79.8	88.0	85.0	85.0	73.5	75.5	75.5			77.3	74.7		[illegible]	[illegible]
Connecticut	99.4	95.8	96.5													
Delaware	99.7	99.3	100.0	90.0	92.0	93.0										
Florida	95.7	94.1	94.1	96.0	96.0	97.0	93.7	94.6	94.4						[illegible]	[illegible]
Georgia	99.4	99.4	99.7	95.0	95.0	95.0	92.1	91.4	91.6	[illegible]	97.5					
Hawaii																
Idaho	93.8	95.8	91.[illegible]	96.0	95.0	95.0										
Illinois	95.8	96.0	96.9	94.2	96.0	97.0	95.6	98.7	97.[illegible]						[illegible]	[illegible]
Indiana	97.6	98.0	97.3				87.1	86.4	87.5						[illegible]	[illegible]
Iowa							93.9	91.7	95.4			95.[illegible]	[illegible]		[illegible]	[illegible]
Kansas	95.9	96.9	94.9				91.3	96.9	92.9			91.0	91.5		[illegible]	[illegible]
Kentucky	93.6	95.9	97.3				94.6	95.1	95.7							
Louisiana	99.7	91.9	97.0	96.0	97.0	96.0	97.6	96.4	92.0							
Maine																
Maryland	98.4	99.3	99.3	92.0	98.0	97.0										
Massachusetts																
Michigan							97.8	97.7	97.8						[illegible]	[illegible]
Minnesota																
Mississippi				93.0	95.0	95.0	87.9	88.5	87.2						[illegible]	[illegible]
Missouri							73.3	74.1	83.7			[illegible]			[illegible]	[illegible]

	Company "A" 1977	April 1978	May 1978	Company "B" 1977	April 1978	May 1978	Company "C" 1977	April 1978	May 1978	Company "D" 1977	Apr.-June 1978	Company "E" 1977	April 1978	May 1978	Company "F"	April 1978	May 1978
Montana																	
Nebraska																	
Nevada																[illegible]	[illegible]
New Hampshire	92.0	91.1	96.3														
New Jersey	97.8	96.2	95.9	95.0	97.6	93.0	96.6	96.4	94.2								
New Mexico				97.0	97.0	98.0						96.6	96.7			[illegible]	[illegible]
New York	97.6	94.4	96.8														
North Carolina				95.0	95.0	95.0	95.1	92.1	96.4								
North Dakota																	
Ohio	95.3	94.7	94.1	95.0	92.0	94.0	96.5	98.6	97.0							[illegible]	[illegible]
Oklahoma	95.1	96.6	96.7	96.0	96.0	95.0	95.0	92.2	98.9			92.3	92.8			[illegible]	[illegible]
Oregon							96.9	94.6	97.6							[illegible]	[illegible]
Pennsylvania	99.6	90.1	94.0	95.0	94.0	95.0	98.0	97.5	98.5							[illegible]	[illegible]
Rhode Island																	
South Carolina				96.0	96.0	95.0	94.1	91.0	92.0								
South Dakota												96.0	92.1				
Tennessee				97.6	98.0	97.0	96.6	96.3	96.5								
Texas				99.0	99.6	93.0	98.2	97.6	96.4			96.6	96.9			[illegible]	[illegible]
Utah				94.0	94.0	99.0										[illegible]	[illegible]
Vermont	95.8	95.2	94.0														
Virginia	97.6	97.6	97.1	96.0	98.0	96.0	95.4	96.1	95.1								
Washington							96.2	92.4	93.5							[illegible]	[illegible]
West Virginia	99.5	97.7	99.8														
Wisconsin				96.0	95.0	95.0											
Wyoming																[illegible]	[illegible]

APPENDIX II

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

February 9, 1979

C. Lee Peeler, Esquire
Federal Trade Commission
Bureau of Consumer Protection
Washington, D. C. 20480

Dear Lee:

Enclosed are copies of two memoranda by David H. Pyle, a visiting scholar in our Banking Research and Economic Analysis Division, in which the Federal Reserve Staff Study on tie-ins in the sale of insurance by bank holding companies is analyzed. The second memorandum may be of particular interest.

You are free to release the memoranda to Congressional committees if you wish. Should you elect instead to simply describe the memoranda in a letter to a Congressional committee, we ask that the Comptroller's staff be mentioned as the source of the opinions expressed in the memoranda.

As I indicated on the telephone, the Comptroller's staff, after analyzing the Study, asked the Federal Reserve staff to generate a new Table 5 based on a sample of only those consumers who took credit insurance. The Federal Reserve agreed to do so, and Table 5' is the result.

Also enclosed is a copy of a letter I wrote dated December 18, 1978, which will be published shortly in the CCH Federal Banking Law Reporter, where many of our staff opinions appear. I sent a copy of it to Lewis Goldfarb on January 17, but you might not have seen it.

Very truly yours,

Ford Barrett

Ford Barrett
Assistant Chief Counsel

Enclosures

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

Jonathan L. Fiechter, Acting Director, Banking Research and Economic Analysis
David H. Pyle, Visiting Scholar, Banking Research and Economic Analysis
December 6, 1978

Federal Reserve Board's Study of Tie-ins Between Extension of Credit and Sales of Insurance.

I have reviewed the Federal Reserve staff study on tie-ins between the extension of credit and sales of insurance by bank holding companies. There are two parts to the study. The first is based on a consumer survey and the second on a survey of bank holding companies. Based on these surveys the authors conclude that

(1) There was a significant amount of joint sales of credit and credit insurance by banks, but
(2) There is no evidence that these sales involved explicit coercion or the involuntary tieing of the two services.

As noted below I do not think that the second conclusion is supported very well by the data.[1]

Consumer Survey

In the consumer survey it was found that a little over 60 percent of bank borrowers obtained credit insurance and something like 97 percent of those who did got the insurance from the lender. The authors of the Fed study agree that these penetration rates are consistent with tie-in sales of insurance. However, they also concluded that "...the high penetration rates do not appear to have arisen from either explicit coercion or involuntary tieing." In reaching that conclusion the authors cite survey responses regarding the pressure consumers felt to purchase credit life and disability insurance when they applied for credit. The sampling method used to obtain this result may be questioned.

The percentage response to each of the questions about pressure to buy credit insurance (e.g. Was insurance strongly recommended?) was based on the total sample of individuals who received credit not just on those who received credit and bought insurance. The argument of the authors is that they were trying to determine the fraction of individuals who obtained credit and who felt they had been pressured to obtain insurance. An alternative view is that the proper base for the sample is those who took the credit insurance. A really good test of the lack of coercion would be to see how many of those who took insurance did so voluntarily. This statistic cannot be imputed from Tables 4 and 5. Since something like 40 percent of the respondents to the survey did not take credit insurance, the authors' finding that 12.1 percent of the full sample thought that credit insurance was required translates into almost 20 percent of those who actually took credit insurance. In fact, as a crude comparison, one might note that the fraction of bank consumers who said that the creditor either never mentioned insurance or mentioned but did not recommend insurance (i.e., customers who received no pressure) is almost identical to the proportion of the consumers who did not take credit insurance. Using the assumption that all of those who did not take insurance fell into the first three response categories of Table 5, one would conclude that over 38 percent of those who bought insurance perceived significant sales pressure.

---

[1] However, I cannot find the source of Lee Peeler's concern about the use of mortgage loans in the Federal Reserve study.

Let me outline a circumstance in which banks could be applying pressure to obtain credit insurance on some borrowers but not on all borrowers. Suppose the bank could decide which individuals are susceptible to coercion. If so the bank's employees might not pressure individuals who might react adversely to this pressure. Yet they might use this strategy to sell insurance to individuals who appear to be more susceptible to this kind of selling technique. In this circumstance, the proper sample for analysis would be those customers who actually bought insurance.

The second argument for the absence of coercion is based upon the small proportion of customers viewing credit life and disability insurance as a bad service. Here again as far as I can tell the sample is for all credit customers so that the 9.5 percent of new car borrowers at banks who thought credit insurance was bad may not be an accurate estimate for those who actually took out credit insurance. The authors also note that most borrowers regarded it as having a price which was about right or even inexpensive (in this case they actually used a sample of those who took out insurance). However it is not clear that the borrowers subject to involuntary tieing are going to find the services bad or the price particularly expensive. Indeed if taking the credit insurance enhances the chance for someone to receive credit then they might be well satisfied with the credit insurance.[2] The point is that it is not certain that the absence of coercion would be signalled by the lack of customers who view credit life and disability insurance as a bad service or an expensive service.

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[2] If there are tied sales of credit and credit insurance, one might expect the ability of banks to tie the sale of these two services to become stronger as credit becomes tighter. On this hypothesis, a consumer survey in the summer of 1978 would be expected to show higher penetration rates than the one taken

However the evidence is not particularly strong in favor of harmful tied sales of credit and credit insurance. The generally positive acceptance of credit insurance by bank customers suggests that they don't feel that they are being harmed significantly by taking out insurance. They may have been sold something that they didn't really need. Whether anybody in the government should concern themselves about this is another story.

Bank Holding Company Survey

In terms of the survey of bank holding companies, the response rate by banks in reporting penetration rates is so abysmal that drawing conclusions from it is very questionable. For reasons that are not clear, most banks just did not supply statistical information on penetration rates.

An interesting proposition coming from the bank holding company survey is the suggestion that insurance solicitation is generally made after the credit is approved. This is based on self-reporting by the banks and is no proof that that is the true sequence of events. If they had it to do over again, the Federal Reserve might ask borrowers about the timing of the credit insurance offer. The question of coercive tieing would tend to be answered in the negative if credit insurance was brought up after credit approval instead of before. However, we only have the self-reporting of the bank holding companies as an indication of the timing of these insurance offers.

Summary

In summary I would interpret the consumer survey slightly differently from the Federal Reserve interpretation. On my interpretation, there is a fairly significant number of individuals who took out credit insurance and who felt some kind of pressure from the lending officer to take out that insurance. However, it is also true that those who take out the insurance do not seem significantly dissatisfied with it. There is an open questions regarding the timing of the insurance relative to the time at which credit is granted.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

To Jonathan L. Fiechter, Acting Director

From David H. Pyle, Visiting Scholar DHP

Date February 5, 1979

Subject Federal Reserve Board's Study of Tie-ins Between Extensions of Credit and Sales of Insurance

On December 6, I reviewed the subject study. In my review, I noted that their claim that bank credit consumers did not experience significant sales pressure to buy credit life insurance was largely based on data from the entire sample of credit customers. I suggested that a table on creditor perceptions for those borrowers who did take credit life insurance would provide more relevant statistics. The Federal Reserve has produced that table and it is attached.

From the new table one can see that 35.9% of those who took credit life insurance felt that it was either strongly recommended or required. This is quite close to my earlier estimate that as many as 38% of those who bought insurance perceived significant sales pressure and is significantly greater than the 23.5% estimate that is obtained if one uses the full sample.

As I suggested earlier, if 35.9% of borrowers who took credit insurance felt significant sales pressure, it is hard to reach the conclusion that joint sales of credit and credit insurance did not involve some type of explicit coercion.

Table 5

Perceptions of Creditors' Recommendations About
Purchase of Credit Insurance by Type of Financial Institutions
(per cent)

umer Response	Banks	Finance Companies	Credit Unions	Retailers
Creditor Never Mentioned Insurance	20.2 %	12.3 %	17.2 %	40.5 %
entioned but not Recommended	18.3	18.7	16.8	8.8
ecommended	28.2	26.5	22.4	23.0
Strongly Recommended	11.4	11.6	5.6	4.7
equired	12.1	23.2	26.3	10.8
equested by Consumer	0.9	1.3	[illegible]	

Other	1.2	0.6	2.6	--
Do Not Know or Not Ascertained	7.6	5.8	7.8	10.8
al*	99.9	100.0	100.0	100.0

y not add to 100 percent because of rounding.

Table 5'

Perceptions of Creditors' Recommendations about Purchase of Credit Insurance by Type of Financial Institution

(Sample of only those consumers who took credit insurance)

sumer Response	Banks	Finance Companies	Credit Unions	Retailers
Creditor Never Mentioned Insurance	6.9 %	3.4 %	9.2 %	10.2
Mentioned but not Recommended	15.0	17.2	14.1	11.9
Recommended	36.1	31.9	25.2	35.6
Strongly Recommended	16.8	13.8	7.4	11.9
Required	19.1	31.0	36.2	25.4
Requested by Consumer	1.4	1.7	1.8	3.4
Other	1.4	0.0	3.7	--
Do Not Know or Not Ascertained	3.2	0.9	1.8	1.7
Total*	99.9	99.9	99.4	100.1

APPENDIX 4

Letter from

The Honorable William Proxmire
Chairman,
Senate Banking Committee
to
The Honorable G. William Miller
Chairman,
Federal Reserve Board

[illegible] WILLIAMS, JR., N.J. JAKE GARN, UTAH
[illegible], CALIF. JOHN TOWER, TEX.
[illegible] STEVENSON, ILL. JOHN HEINZ, PA.
[illegible], N.C. WILLIAM L. ARMSTRONG, COLO.
[illegible] RIEGLE, JR., MICH. NANCY LANDON KASSEBAUM, KANS.
[illegible] SARBANES, MD. RICHARD G. LUGAR, IND.
[illegible] STEWART, ALA.
[illegible] TSONGAS, MASS.

KENNETH A. MC LEAN, STAFF DIRECTOR
M. DANNY WALL, MINORITY STAFF DIRECTOR
MARY FRANCES DE LA PAVA, CHIEF CLERK

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, D.C. 20510

July 11, 1979

The Honorable G. William Miller
Chairman, Board of Governors of
the Federal Reserve System
Washington, D.C. 20551

Dear Mr. Chairman:

This Committee recently held hearings on tie-in sales of insurance in connection with the extension of credit by banks and bank holding companies. The hearing focused on the Federal Reserve study titled, "Tie-ins Between the Granting of Credit and Sale of Insurance".

The record developed at these hearings overwhelmingly substantiates past allegations of rampant abuse of consumers who are required to purchase insurance when they obtain credit by banks and bank holding companies.

The Bank Holding Company Act Amendments of 1970 are designed to prohibit implicit as well as explicit tie-ins of bank holding companies and their subsidiaries. Section 4(c)(8) requires the Federal Reserve in approving a particular activity as "closely related" to banking to find that the public benefits outweigh adverse effects and to prevent industry structures that may facilitate implicit or voluntary tying of bank credit to nonbank services.

The basic data in the Federal Reserve's tie-in study show that tie-ins are a significant problem. One statistic shows that 52 percent of bank borrowers are recommended, strongly recommended, or required to purchase insurance. Less than one percent of such borrowers request insurance. The resultant large number of consumers purchasing insurance shows that these consumer borrowers get the message -- i.e., buy the insurance.

While the Federal Reserve's study focused largely on credit insurance, the conclusions which follow from the facts of the study may be applied to the full range of nonbank services offered by banks and bank holding companies.

Much criticism at the hearing was leveled at the Federal Reserve's conclusions drawn from the facts of the tie-in study. I agree with these criticisms. The Federal Reserve's conclusions in the study appear to me to whitewash the severe tie-in facts uncovered in its study. I call this to your attention in the hope that you will personally review the record of these hearings.

Moreover, it appears that the Federal Reserve should re-examine its regulatory approach to nonbank activities of bank holding companies. Specifically the Federal Reserve should (1) review its regulatory policy toward credit insurance with a view toward reducing the wholly unwarranted income to the banking industry resulting from the windfall that accrues to them because they have the credit-making leverage and (2) review its regulatory policy of approving nonbank activities under Section 4(c)(8) to prohibit any activity as "closely related" to banking which poses any substantial risk of tie-ins such as those uncovered in the Federal Reserve tie-in study.

These are steps which the Federal Reserve can take even without further legislation and which would carry out the intent of existing laws. Of course, I continue to remain hopeful that the Federal Reserve will support the kind of bank holding company reform encompassed in S. 39.

Finally, it seems to me that the Federal Reserve should conduct a further study of tie-ins of insurance, which would focus on consumer and business attitudes involving the sale of property and casualty insurance. Committee staff is available to work with your staff in devising a suitable attitude survey.

Sincerely,

William Proxmire
Chairman

WP:lml

APPENDIX 5

Federal Trade Commission Decision

In the Matter of

Guardian Loan Company, Inc.

88 F.T.C. 632 (1976)

IN THE MATTER OF

GUARDIAN LOAN COMPANY, INC.

CONSENT ORDER, ETC., IN REGARD TO ALLEGED VIOLATION OF THE FEDERAL TRADE COMMISSION AND TRUTH IN LENDING ACTS

Docket C-2846. Complaint, Oct. 20, 1976 — Decision, Oct. 20, 1976

Consent order requiring a Roslyn Heights, N.Y., consumer finance company, among other things to cease violating the Truth in Lending Act by failing to disclose to consumers, in connection with the extension of consumer credit such information as required by Regulation Z of the said Act. Further, respondent is required to cease misrepresenting the terms and conditions of insurance coverage requirements; to display insurance information in-house; to mail insurance disclosure letters together with cancellation forms to customers; to send customer-requested refunds within a specified time; and to maintain records.

Appearances

For the Commission: *Angelo M. Presti.*

For the respondent: *Walter C. Wallace, Stein, Mitchell & Mezines,* Washington, D.C.

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act, and the Truth in Lending Act and the regulation promulgated thereunder, and by virtue of the authority vested in it by said Acts, the Federal Trade Commission, having reason to believe that Guardian Loan Company, Inc., a corporation, hereinafter sometimes referred to as respondent, has violated the provisions of said Acts and implementing regulation, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint stating its charges in that respect as follows:

PARAGRAPH 1. Respondent Guardian Loan Company, Inc. is a corporation organized, existing and doing business under and by virtue of the laws of the State of New York, with its office and principal place of business located at 2 Lambert St., Roslyn Heights, New York.

Respondent Guardian Loan Company, Inc. operates through approximately thirty (30) wholly-owned subsidiary loan offices located in the States of New York, New Jersey, Pennsylvania, Delaware and Connecticut. Respondent Guardian Loan Company, Inc. formulates and controls the policies, acts and practices of each of the wholly-owned subsidiaries, including the acts and practices hereinafter set forth.

PAR. 2. Respondent, by and through its various wholly-owned subsidiary corporations, is now, and for some time in the past has been, engaged in consumer financing and the granting of consumer loans to members of the public in the States of New York, New Jersey, Pennsylvania, Delaware and Connecticut.

PAR. 3. In the ordinary course and conduct of its business, as aforesaid, respondent regularly extends consumer credit, as "consumer credit" is defined in Regulation Z, the implementing regulation of the Truth in Lending Act, duly promulgated by the Board of Governors of the Federal Reserve System.

PAR. 4. Subsequent to July 1, 1969, respondent, in the ordinary course and conduct of its business, as aforesaid, has charged, and is now charging, a substantial number of consumers for credit life and credit disability insurance written in connection with consumer loans.

Typical and illustrative, but not all inclusive, of the circumstances in which such insurance charges are incurred by consumers are the following, which generally occur in the sequence set forth.

1. During the consumer's initial contact with respondent, either on the telephone or in person, respondent orally quotes a monthly repayment figure which includes charges for credit life and credit disability insurance.

2. Respondent automatically includes charges for credit life and credit disability insurance on the Disclosure Statement of Loan, and, unless the consumer specifically objects to the inclusion of the charges for such insurance, the coverage becomes part of the credit transaction.

3. On that portion of the Disclosure Statement of Loan which contains the statements "I desire Credit Life Insurance the cost of which is shown above ( ) Yes ( ) No," and "I desire Disability Insurance the cost of which is shown above ( ) Yes ( ) No," followed by a line for the consumer's signature, respondent, without the permission or authority of the consumer, checks the "Yes" boxes and then dates and places an "X" on the line for the borrower's signature.

4. The Disclosure Statement of Loan, filled out as indicated above, is presented to the consumer for two signatures, and the consumer is told by respondent's employees to sign next to the "X's" respondent's employees have made. The consumer is not told the purpose of each signature. These signatures are intended (1) to indicate the consumer's request for the insurance coverage, and (2) to acknowledge the consumer's receipt of the completed Disclosure Statement of Loan,

5. If a consumer is told the purpose of each signature mentioned in part 4 of Paragraph Four above, the consumer is not subsequently told whether or not credit life and credit disability insurance are optional.

6. Respondent places the charges for credit life and credit disability insurance in the Disclosure Statement of Loan, and these charges

become part of the "amount financed," but are not included in the amount of the "finance charge" which "finance charge" is used in the computation of the "annual percentage rate."

7. If a consumer becomes aware that he has a choice about obtaining credit life and/or credit disability insurance and specifically objects to or questions the inclusion of the charges for such insurance, respondent informs the customer that deletion of such charges will require it to have all the loan papers retyped as well as drawing a new check for the amount of the proceeds of the loan, and that this process of redoing the papers will result in delaying the completion of the loan, sometimes by as much as several days.

PAR. 5. By and through the acts and practices described in Paragraph Four, and others of similar import, meaning and consequence, but not specifically set forth herein, respondent, in a substantial number of instances, obtains consumers' signatures through practices which operate, directly or indirectly, to defeat the elective language of the insurance authorization disclosures by obscuring from consumers knowledge about the option, by misrepresenting to consumers that their signatures are necessary solely for the purpose of consummating the credit transaction, and by discouraging the declination of the coverage when it is questioned. These practices have the effect of preventing substantial numbers of consumers from exercising their own independent, voluntary choice whether to obtain credit life and/or credit disability insurance.

Therefore, respondent, in a substantial number of instances, induces its customers to incur charges for credit life and credit disability insurance without said customers making a knowing, affirmative election to have such insurance and, thereby, respondent has failed to obtain from each of its customers a "specific dated and separately signed affirmative written indication of [their] desire" to obtain such insurance, as required by Section 226.4(a)(5) of Regulation Z, despite the existence of language to the contrary in the Disclosure Statement of Loan.

PAR. 6. By and through the acts and practices described in Paragraphs Four and Five hereof, respondent has failed to include the charges for credit life and credit disability insurance in the "finance charge" when a specific dated and separately signed affirmative written indication of the consumer's desire for such insurance has not been obtained, as required by Section 226.4(a)(5) of Regulation Z, and thereby respondent:

1. Failed to compute and disclose accurately the "finance charge" as required by Sections 226.4 and 226.8 of Regulation Z; and

2. Failed to compute and disclose the "annual percentage rate"

accurately to the nearest quarter of one percent, as required by Sections 226.5 and 226.8 of Regulation Z.

PAR. 7. Subsequent to July 1, 1969, respondent, in the ordinary course and conduct of its business, as aforesaid, has furnished Disclosure Statement of Loan forms to its customers. By and through the use of said forms, respondent, in many instances, failed to use the term "amount financed" to describe the amount of credit extended as required by Section 226.8(d)(1) of Regulation Z.

PAR. 8. Pursuant to Section 103(q) of the Truth in Lending Act, respondent's aforesaid failures to comply with Sections 226.4, 226.5, and 226.8 of Regulation Z constitute violations of that Act and, pursuant to Section 108 thereof, respondent has thereby violated the Federal Trade Commission Act.

DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of the respondent named in the caption hereof, and the respondent having been furnished thereafter with a copy of a draft of complaint which the New York Regional Office proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondent with violation of the Truth in Lending Act and the regulation promulgated thereunder and violation of the Federal Trade Commission Act; and

The respondent and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it had reason to believe that the respondent has violated the said Acts, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings, and enters the following order:

1. Respondent Guardian Loan Company, Inc. is a corporation organized, existing and doing business under and by virtue of the laws

of the State of New York, with its office and principal place of business located at 2 Lambert St., Roslyn Heights, New York.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

ORDER

For purposes of this order, the following definitions of terms shall apply:

(a) "consumer loans in open status" refers to those consumer loans in which payments at least totaling the amount of one regular monthly payment have been made by the borrower in the last six months.

(b) "delinquent account" refers to those accounts which are more than 30 days past due for an amount which equals the amount of one regular monthly payment.

(c) "net cash advance" refers to the actual amount of cash that a borrower will receive after choosing one of the credit insurance options available. including that option which contains no credit insurance, in connection with his loan.

(d) "penetration rate" refers to the percentage of all loans eligible for credit insurance on which charges for such insurance are made.

(e) "refund method" refers to an accounting method to compute refunds of insurance premiums in connection with cancellation of insurance coverage which method makes use of both the Rule of 78 and a pro rata computation. As an example, the Rule of 78 would operate on a 12-month loan as follows: The numbers 1 through 12 added together provide the figure 78. This is the denominator. The sum of the months expired at the date of cancellation supplies the numerator. The first month of a 12-month loan is considered as 12 because the outstanding balance is 12 times as large during the first month as it is for the last month. The second month is 11, and so on, to 1. The portion of insurance premiums which must be refunded is, for cancellation during the first month, 78/78-12/78 or 66/78; second month 66/78-11/78 or 55/78; and so on down to the 12th month. The numerator for a 24-month contract is obtained by beginning with 24, instead of 12, as for a 12-month contract, or 36 in the case of a 36-month contract or any other number denoting the total number of months or periods in a particular contract. To the amount of any refund due in connection with any loan as determined by use of the Rule of 78 will be added an amount which is equal to 40 percent of the difference between said Rule of 78 amount and that amount which would be due if said refund were to be computed on a pro rata basis. Said pro rata amount refers to an amount which shall be at least as great a proportion of the total insurance premiums collected by respondent in connection with any loan as the number of remaining monthly payments, scheduled to follow the installment date nearest the date of cancellation as explained below, bears to the total number of monthly payments scheduled by the loan contract. Any cancellation made on or before the fifteenth day following an installment date shall be deemed to have been made on the installment date immediately preceding the date of cancellation. Any cancellation made after the fifteenth day following an installment date shall be deemed to have been made on the installment date immediately following the date of cancellation. Any borrower making cancellation on or before the fifteenth day following consummation of the loan shall receive a refund or credit for the full amount of insurance premiums in connection with said loan. Cancellation for purposes of computing the amount of any refund or credit due shall be as of the date of receipt by respondent of the notice set forth in Attachment C of this order or as of the date of receipt by respondent of any other communication from the borrower under the terms of this order indicating his desire to cancel his insurance coverage.

(f) "time of closing" refers to that period of time during which loan documents are presented to the borrower for consummation of a loan transaction whereby the borrower becomes obligated to make payments to respondent to satisfy said loan.

I.

It is ordered, That respondent Guardian Loan Company, Inc., its successors and assigns, and its officers, and respondent's agents, representatives and employees, directly or through any corporation, subsidiary, division or other device, in connection with the granting of consumer loans subject to the provisions of Regulation Z (12 CFR §226.8) of the Truth in Lending Act (Pub. Law 90-321, 15 U.S.C. §1601, *et seq.*), do forthwith cease and desist from:

1. Failing, when the charges for credit life insurance and/or credit disability insurance are not included in the finance charge for consumer loans:

(a) To present to the borrower as the first document at the time of closing, which document shall be the first document to be completed by respondent and the first document to be signed by the borrower(s) at the time of said closing in respondent's loan offices, or to mail to the borrower, who is consummating his loan through the mail, at the same time as consummation papers are to be mailed, a separate, written, personal insurance authorization form which sets forth clearly and conspicuously:

(i) the borrower has received credit approval up to a specified amount:

(ii) the borrower's decision with regard to the insurance available through respondent is not considered in granting the credit:

(iii) the purchase of credit insurance is optional and is not required by Guardian Loan Company, Inc., in connection with the loan:

(iv) the amount of the total premium for credit life insurance and the amount of the total premium for credit disability insurance [which, if elected, will be deducted from the amount of the proceeds and added to the "amount financed"]:

(v) the net cash advance options which would result from the borrower's election to take the loan, set forth in the following order from left to right across the document: (1) without either credit life insurance or credit disability insurance, (2) with credit life insurance only, (3) with credit disability insurance only, (4) with both credit life insurance and credit disability insurance, (5) with other available forms of credit insurance, if applicable, except that, in any State where credit property insurance is available alone as well as in multiple combinations or options with other forms of credit insurance, respondent, in addition to providing the required information for the above stated four options, need only provide the required information for one other option if the borrower has indicated an interest in such an option:

(vi) a signature and date line for each option set forth in (v) above for the borrower(s) to indicate his election:

(vii) the borrower authorizes respondent on behalf of the borrower to pay the insurance premiums to the insurance company for such personal insurance which has been chosen.

(b) To send to mail order loan borrowers, at the same time and along with the papers to consummate said loan, a separate written statement containing the notice, in no less than 12 point bold type and easily legible, which this order requires to be displayed at respondent's loan offices.

(c) To make the disclosures required by subparagraph (a) above on a separate document which contains no other printed or written material.

(d) To make disclosures required by subparagraphs (i), (ii) and (iii) above in not less than 12 point type. A form substantially in conformance with Attachment A herein will be considered as in compliance with the provisions of subparagraphs (a), (b) and (c) above. Respondent shall maintain the original statement for two years following its execution and provide the customer with an executed copy thereof.

2. Making any marks or otherwise instructing a borrower where to sign or date the separate personal insurance authorization form

required by subparagraph (a) above in advance of the borrower's free and independent choice for such insurance.

3. Misrepresenting, orally or otherwise, directly or by implication, that credit life and/or credit disability insurance are required as a condition of obtaining credit from respondent.

4. Discouraging, by misrepresentation, oral or otherwise, directly or by implication, the declination of credit life and/or credit disability insurance.

5. Representing, orally or otherwise, directly or indirectly, that the borrower's failure to elect credit insurance will result in a delay in processing his loan or in his receiving the proceeds.

6. Failing to compute and disclose accurately the finance charge, as required by Section 226.4(a)(5) and 226.8(d) of Regulation Z.

7. Failing to compute and disclose accurately the annual percentage rate to the nearest quarter of one percent as required by Section 226.5(b) and 226.8(b) of Regulation Z.

8. Failing to use the term "amount financed" to describe the amount of credit extended as required by Section 226.8(d)(1) of Regulation Z.

9. Failing, in any consumer loan transaction or advertisement, to make all disclosures, in accordance with Section 226.4 and 226.5 of Regulation Z, in the manner, form and amount required by Section 226.6, 226.8, 226.9 and 226.10 of Regulation Z.

II.

It is further ordered, That respondent display at each booth, or at or near each desk or other location where loans are consummated, in such a manner and in such dimensions so as to be easily viewed and read by the borrower from his seated or other normal position in such booth or at such desk or other location, and which shall not be in close proximity to any other written or display material, the following notice:

NOTICE TO BORROWERS

> THE PURCHASE OF CREDIT INSURANCE IS OPTIONAL AND IS NOT REQUIRED BY THIS COMPANY IN CONNECTION WITH YOUR LOAN. YOUR DECISION WITH REGARD TO THE INSURANCE AVAILABLE IS NOT CONSIDERED BY THIS COMPANY IN THE GRANTING OR DENYING OF CREDIT TO YOU.

III.

It is further ordered, That respondent maintain records on a State-by-State basis (covering each State in which they do business) of the penetration rate of (a) credit life insurance for loans: and (b) credit disability insurance for loans. Such records shall be maintained on a yearly basis and submitted to the Commission each year for a period of five years, and thereafter from time to time as the Commission may request.

IV.

It is further ordered, That respondent, in reporting penetration rates, state the total number and dollar amount of loans entered into each year which were eligible for credit insurance, stated separately for credit life insurance and credit disability insurance.

V.

It is further ordered, That within forty-five (45) days after the date this order becomes final respondent mail to all borrowers to whom credit life and/or credit disability insurance were sold prior to the date this order becomes final and the premium(s) for same were not included in the finance charge, and who did not receive death benefits or health benefits under said insurance policies, in connection with respondent's consumer loans in open status on the date this order becomes final, notwithstanding the sale or assignment of any or all of said loans to a third party, the two notices set forth in Attachments B and C of this order, together with a self-addressed, postpaid, return envelope.

VI.

It is further ordered, That within forty-five (45) days after the date this order becomes final respondent contact by telephone or other means available all those borrowers who would be sent, under the terms of this order, the notices set forth in Attachments B and C of this order were it not for the fact that said borrowers have been extended confidential loans by respondent under the terms of which no correspondence is forwarded by mail to said borrowers, in order to advise said borrowers of their prerogatives to cancel their insurance coverage and receive a partial refund of the insurance premiums paid:

Provided, however, That any obligation under Paragraphs V and VI above shall only apply to respondent and shall not apply to: (a) any third party to whom said loans may be or may have been sold or assigned, (b) any offices of respondent transferred to a third party in connection with the sale or assignment of said loans, or (c) any of said loans sold or assigned to a third party;

Provided further, however, That it is understood that any of said loans sold or assigned to a third party shall be used by respondent pursuant to the terms of Paragraphs V and VI above solely to determine the names of the borrowers required by it to fulfill its obligation under said paragraphs and the amount of each insurance premium refund which may be required pursuant to respondent's fulfillment of such obligation;

Provided further, however, That respondent shall not be required to forward the two notices set forth in Attachments B and C of this order to any borrower, or to contact any borrower who has been extended a confidential loan, who has already received the above-mentioned notices prior to the date this order becomes final, or who has already been contacted by respondent with respect to cancellation of insurance coverage prior to the date this order becomes final, and where any and all follow-up provisions required by this order with respect to said notices or contact, including the making of refunds or the crediting of accounts, where applicable, have been or will be accomplished by respondent within the time periods specified in this order;

Provided further, however, That respondent shall not be required to forward the two notices set forth in Attachments B and C of this order to any borrower who, for any loan consummated prior to the date this order becomes final, received from respondent during the time of closing of said loan the personal insurance authorization form required by Section 1(a) of this order and where any and all requirements connected with said form as required by this order have been accomplished by respondent.

VII.

It is further ordered, That a record of mailing by respondent of the notices set forth in Attachments B and C of this order be kept by respondent and that said record be available for examination by Commission personnel in connection with any compliance obligations arising out of this order.

VIII.

It is further ordered, That all telephone calls or other attempts to advise the above-mentioned confidential loan borrowers of their cancellation prerogatives be noted on the ledger cards of such borrowers so as to legibly indicate: (1) the dates and times of such telephone calls or other means of communication employed to make contact with said borrowers; (2) the results of such attempts; and (3) the name or initials of respondent's employee making such contacts.

Respondent's obligations under Paragraphs V and VI of this order shall not be fulfilled until each borrower affected by said paragraphs has received the notices, or been contacted, as specified therein; *provided however,* that respondent shall be deemed to have complied with said Paragraphs V and VI if respondent can demonstrate that it expended reasonable efforts, in writing or orally, to deliver such notices or make such contact according to the terms of this order.

IX.

It is further ordered, That any and all requests for refunds of insurance premiums under the terms of this order be made by respondent based on the Refund Method as defined in this order and that said refunds be made by respondent within thirty (30) days of receipt by respondent, within the time period specified in this order, of the notice set forth in Attachment C of this order or receipt by respondent of any other form of communication from borrowers indicating their desire to cancel their credit insurance coverage:

Provided, however, That respondent under Paragraph IX above shall have the option in connection with open status but delinquent accounts to either make refunds in accordance with the terms of this order or to credit said accounts for the full amount of any refunds due.

X.

It is further ordered, That respondent, when crediting any delinquent account with the full amount of any refund due following receipt of the notice set forth in Attachment C of this order, or following contact with any borrower under the terms of this order, credit said account within thirty (30) days of the receipt by respondent of said notice or within thirty (30) days of the contact by respondent whereby the borrower indicates his desire to cancel his credit insurance coverage.

XI.

It is further ordered, That the above-mentioned credit be reflected on the next account status statement to be sent to the borrower following the above-mentioned crediting of his account;

Provided, however, That respondent shall not be required under Paragraphs IX and X above to make refunds or to credit accounts with respect to any cancellation notice, as so set forth in Attachment C of this order, or any cancellation request, received by respondent later than twenty-one (21) days following the post office receipt date of said notice's mailing by respondent or later than twenty-one (21) days from the date that respondent otherwise notifies the borrower of his cancellation prerogatives.

XII.

It is further ordered, That respondent deliver a copy of this order to cease and desist to all present and future personnel of respondent at its general offices in Roslyn Heights, New York and in each of its subsidiary loan offices who are engaged in the extension of consumer loans, and that respondent secure a signed statement acknowledging receipt of said copy of this order from each such person.

XIII.

It is further ordered, That respondent notify the Commission within thirty (30) days of any change in the corporate respondent which may affect compliance obligations with regard to the extension of consumer loans arising out of this order, such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or any other change in the corporation with regard to the extension of consumer loans which may affect compliance obligations arising out of this order.

XIV.

It is further ordered, That the respondent herein shall within sixty (60) days after service upon it of this order file with the Commission, a report, in writing, setting forth in detail the manner and form in which it has complied with this order.

Commissioner Dole not participating by reason of absence.

ATTACHMENT A

PERSONAL CREDIT INSURANCE AUTHORIZATION

YOUR LOAN (OTHER EXTENSION OF CREDIT) HAS BEEN APPROVED IN THE AMOUNT OF _____

CREDIT LIFE OR CREDIT ACCIDENT & HEALTH (DISABILITY) INSURANCE IS NOT REQUIRED IN CONNECTION WITH THIS EXTENSION OF CREDIT TO YOU AND YOUR DECISION WITH REGARD TO THE PERSONAL INSURANCE WILL NOT AFFECT THE TOTAL AMOUNT OF CREDIT WHICH HAS ALREADY BEEN APPROVED FOR YOU.

IF YOU ELECT CREDIT INSURANCE THESE PREMIUMS WILL BE DEDUCTED FROM THE PROCEEDS OF YOUR LOAN AND ADDED TO THE AMOUNT FINANCED.

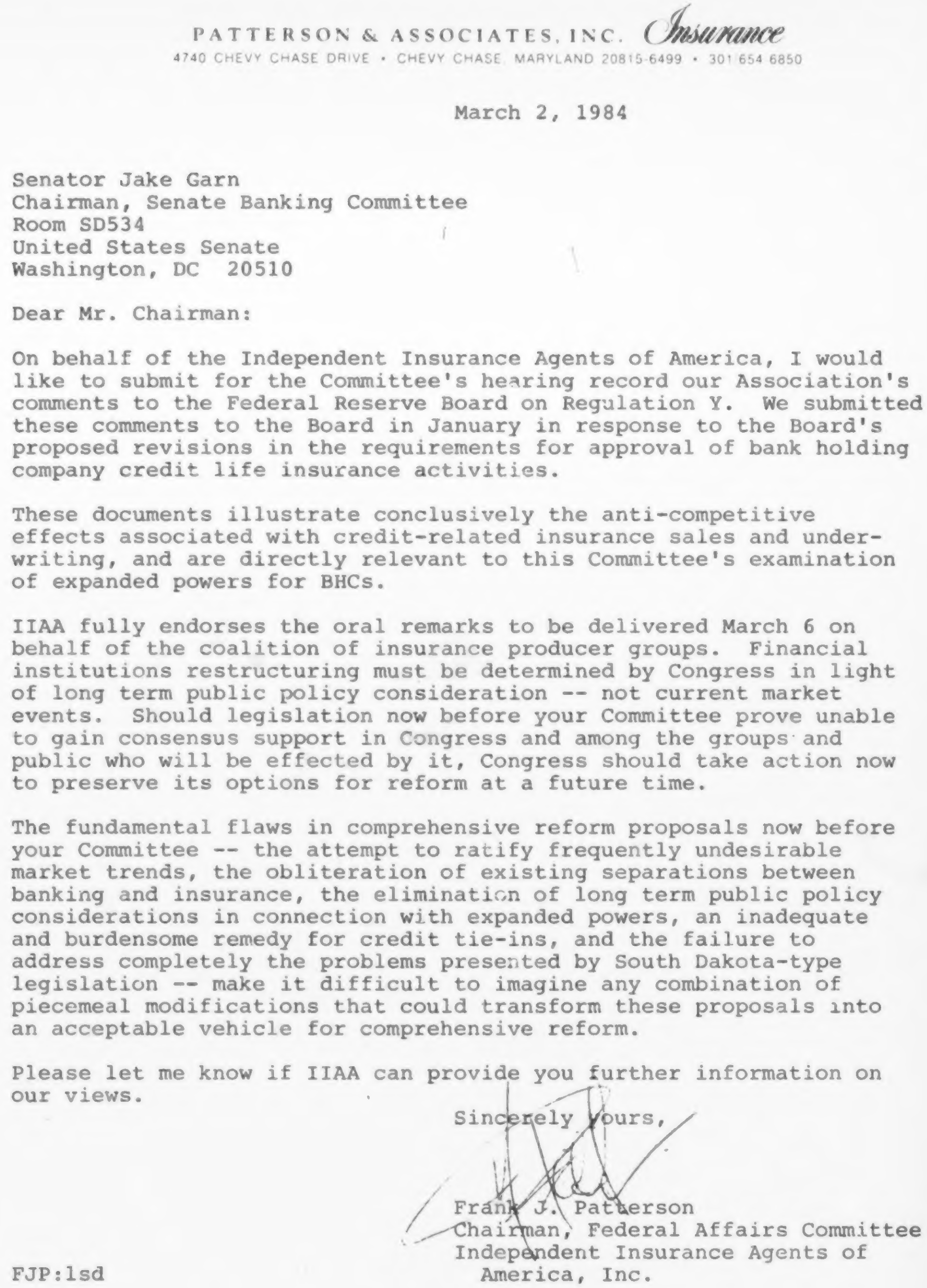
Credit Life $ _____ (For term of transaction)
Credit A & H (Disability) $ _____ (For term of transaction)

I have received a fully completed and executed copy of this form. I have reviewed the net cash advance options set forth below and understand that if I choose a net cash advance option that includes any of the insurance coverages I am authorizing the lender to pay the insurance premiums on my behalf. I have voluntarily chosen the following net cash advance option:

(NOTE: DO NOT SIGN OR RETURN THIS FORM IF YOU WANT YOUR CREDIT INSURANCE TO REMAIN IN FORCE)

DATE _______________ _______________
Borrower

Statement of Ken Osborne, Member, Federal Affairs Committee, Independent Insurance Agents of America; President, Superior Insurance Service, Salt Lake City, Utah



PATTERSON & ASSOCIATES, INC. *Insurance*
4740 CHEVY CHASE DRIVE • CHEVY CHASE, MARYLAND 20815-6499 • 301/654-6850

March 2, 1984

Senator Jake Garn
Chairman, Senate Banking Committee
Room SD534
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

On behalf of the Independent Insurance Agents of America, I would like to submit for the Committee's hearing record our Association's comments to the Federal Reserve Board on Regulation Y. We submitted these comments to the Board in January in response to the Board's proposed revisions in the requirements for approval of bank holding company credit life insurance activities.

These documents illustrate conclusively the anti-competitive effects associated with credit-related insurance sales and underwriting, and are directly relevant to this Committee's examination of expanded powers for BHCs.

IIAA fully endorses the oral remarks to be delivered March 6 on behalf of the coalition of insurance producer groups. Financial institutions restructuring must be determined by Congress in light of long term public policy consideration -- not current market events. Should legislation now before your Committee prove unable to gain consensus support in Congress and among the groups and public who will be effected by it, Congress should take action now to preserve its options for reform at a future time.

The fundamental flaws in comprehensive reform proposals now before your Committee -- the attempt to ratify frequently undesirable market trends, the obliteration of existing separations between banking and insurance, the elimination of long term public policy considerations in connection with expanded powers, an inadequate and burdensome remedy for credit tie-ins, and the failure to address completely the problems presented by South Dakota-type legislation -- make it difficult to imagine any combination of piecemeal modifications that could transform these proposals into an acceptable vehicle for comprehensive reform.

Please let me know if IIAA can provide you further information on our views.

Sincerely yours,

Frank J. Patterson
Chairman, Federal Affairs Committee
Independent Insurance Agents of
America, Inc.

FJP:lsd

COMMENTS OF THE
INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.

Pursuant to

Request for Comments by the

Board of Governors of the Federal Reserve System

To a Proposed Rulemaking Revising

12 CFR Part 225, Footnote 10a

Bank Holding Companies and Change in Banking Control;
Regulation Y; Nonbanking Activity; Elimination of Rate
Reduction Requirement from Credit Life and Credit
Accident and Health Insurance Underwriting

Docket No: R-0491

Submitted By:

Lawrenee-R. Herman
Director of Congressional Relations
Independent Insurance Agents of America, Inc
600 Pennsylvania Avenue, S.E., Suite 200
Washington, D.C. 20003
(202) 544-5833

January 24, 1984

Docket No: R-0491

Comments of the

INDEPENDENT INSURANCE AGENTS OF AMERICA, INC

I. INTRODUCTION

The Board of Governors of the Federal Reserve System ("the Board") has proposed regulations that would revise 12 CFR Part 225 of the Board"s Regulation Y by removing footnote 10a from 225.4(a)(10). That footnote requires an applicant seeking approval to engage in the activity of credit life and credit accident and health insurance underwriting to provide rate reductions or increased policy benefits for such insurance. To assist in its determination of whether to promulgate the revised regulation, the Board has invited interested parties to express their views on the proposed new regulation.

The Independent Insurance Agents of America, Inc. ("IIAA") welcomes this opportunity to submit comments on the Board's proposed revision of 12 CFR 225.4(a)(10). IIAA is the largest association of independent insurance agents in America, representing more than 220,000 independent insurance agents and their employees. Member agents market and service all lines of insurance.

A. Nature and Background of the Board's Proposal

The Board's proposal must be analyzed within the context of existing law and practice. The Bank Holding Company Act of 1956, as amended 12 USC 1841 et seq. ("BHC Act"), generally prohibits a bank holding company from engaging in nonbanking activities or acquiring voting securities of a nonbanking company. However, section 4(c)(8) of the BHC Act establishes an exception for activities "which the Board... has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." Under authority of this section, the Board has found by regulation that 15 nonbanking activities are closely related to banking within the meaning of section 4(c)(8). These activities are specified in the Board's Regulation Y. 12 CFR Part 225. Among the activities approved by the Board in Regulation Y is acting as underwriter for credit life and credit accident and health insurance that is directly related to extensions of credit by the bank holding company system. 12 CFR 225.4(a)(10).

In addition to requiring that activities be closely related to banking, section 4(c)(8) of the BHC Act imposes a net public benefits test on bank holding companies seeking to engage in activities listed in Regulation Y. That is:

> In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices. 12 U.S.C. 1843(c)(8).

In its 1972 decision adopting as a permissible nonbanking activity the underwriting of credit life and credit accident and health insurance, the Board determined that there were potential adverse effects associated with its performance by bank holding companies. Therefore, in order to outweigh these adverse effects, and to satisfy the net public benefits test contained in the BHC Act, the Board required by regulation that bank holding companies desiring to engage in the activity provide rate reductions or increased policy benefits. The Board's regulation states:

> To assure that engaging in the underwriting of credit life and credit accident and health insurance can reasonably be expected to be in the public interest, the Board will only approve applications in which an applicant demonstrates that approval will benefit the consumer or result in other public benefits. Normally such a showing will be made by a projected reduction in rate or increase in policy benefits due to bank holding company performance of this service. 12 CFR 225.4(a)(10)n.10a

In 1976, the Board issued an interpretation of Regulation Y that imposed upon bank holding companies engaged in credit life and credit accident and health insurance underwriting the obligation to maintain these rate reductions or increased policy benefits on a continuing basis. 12 CFR 225.135(d). To implement these requirements, Board staff has published schedules of the rate reductions required in specified states in order to obtain the Board's approval. As a result of these actions, all applications to engage in credit insurance underwriting approved by the Board since 1971 have contained rate reductions.

It should be noted here that these rate reductions are applied, not to the actual market rates used by insurers in a given State, but rather to the maximum — or prima facie rate — allowed within the State. Thus, in practice, the rates applied by BHC's are not necessarily lower — in fact they are virtually never lower — than those used by most competing institutions. Nonetheless, the Board was recently petitioned to eliminate the regulation requiring bank holding companies engaged in underwriting credit life and credit accident and health insurance to apply these marginal rate reductions by way of meeting their net public benefits test. Petitioning bank holding companies maintain that this requirement be eliminated for two reasons: (1) the rate reduction places them at a competitive disadvantage relative to other providers of this service, and (2) no significant evidence of the potential adverse effects, that prompted the Board's regulations in 1972, has been produced.

B. Position of IIAA: Summary

Based upon our examination of the evidence, we conclude that both of these contentions are erroneous. Specifically, we find that bank holding companies in fact operate at a unqiue competitive advantage in the sale and underwriting of credit life and credit accident and health insurance, and that there is ample evidence of significant adverse effects resulting from the sale of these products in conjunction with the extension of credit. Our recommendations, thus, go beyond merely retaining the regulations contained in 12 CFR 225.4(a)(10)n.10a. We would urge the Board to adopt regulations that give practical effect to the Congressional intent behind the net public benefits test. Specifically, we believe the public would be best served by the Board promulgating rules that would: (1) place the extension of credit and the sale of credit related insurance at arm's length, (2) require full disclosure to bank customers of product cost, coverage and availability, and (3) apply the meritorious policy of rate reductions to going market rates rather than to the universally ignored and wholly irrelevant prima facie rates.

In the appendix to these comments are attached several documents that provide empirical evidence in support of our findings, conclusions, and recommendations. These documents are identified at the conclusion of these comments. The points established by these documents, and elaborated upon below, can be summarized as follows:

- Credit related insurance represents a legitimate and valuable consumer service when provided to the consumer in an open, professional and conscientious manner.
- Historically, however, credit related insurance has been fraught with anti-consumer and anti-competitive practices that have been roundly criticized by various State and Federal regulatory bodies.
- As a consequence of the scrutiny of these State and Federal regulatory bodies, many of the more eggregious abuses have been diminished or eliminated.
- This regulatory and enforcement activity has not succeeded in completely eliminating anti-consumer and anti-competitive practices associated with credit related insurance, largely due to the very nature of this particular insurance product as well as the manner in which it has come to be marketed.
- This inherent problem associated with credit related insurance is manifested in at least three general fashions: (1) The phenomenon of "reverse competition" (2) The significant disparity in bargaining power between the parties to the transaction and (3) The perception of a tie-in by the consumer between the extension of a loan and the purchase of credit related insurance.

- The anti-competitive effects intrinsic to credit related insurance are frequently exacerbated by the practices of provider institutions.
- The anti-competitive and anti-consumer effects associate with the sale of credit insurance have been especially evident in bank holding companies, banks and savings and loan associations.

II. NATURE AND HISTORY OF CONSUMER CREDIT INSURANCE

With the introduction of modern consumer credit, at the turn of the century, came the development of consumer credit insurance. The first such insurance was made available in 1917. The problems and abuses associated with consumer credit insurance, however, apparently did not become acute until the tremendous growth of consumer credit installment plans following World War II. (Appendix 1, p. 1).

Two main types of consumer credit insurance have evolved: (1) credit life insurance, and (2) credit accident and health insurance. Both of these types of insurance may be obtained either as an individual policy or as a group policy, with the latter being the most prevalent. Another less common type of consumer credit insurance is credit property insurance.

Two types of insurance companies currently write consumer credit insurance: (1) specialty, and (2) general. Specialty companies are organized to write almost exclusively credit insurance and general companies are full-line life and property insurance companies that include credit insurance as part of their overall business. A third type of company handling credit insurance is the captive company owned by a creditor. Few of these companies write credit insurance directly, but instead reinsure what the creditor writes directly with the regular credit insurance companies. Credit insurance is sold through several types of creditors including small loan companies, banks, savings and loan institutions, retail sales companies, credit unions, and through bank holding companies.

Under credit insurance, the creditor is the beneficiary of the policy and the premiums are paid by the creditor to the insurer. The premiums are assessed in basically in two ways: (1) initial single premium, or (2) periodic billings. With the single premium, the creditor is charged a flat rate per $100 of initial indebtedness per year. Under the periodic billing method, the premium is an amount per $1,000 of loans outstanding per month. Whatever the method, the charge for insurance is usually passed on to the debtor by the creditor. The National Association of Insurance Commissioners ("NAIC") recently reported:

> The creditor usually receives compensation or retrospective rate credits from the sale of the credit insurance from the insurer. The creditors compensation usually depends on the creditor's claim experience and the size of premiums. When the premium the insurer has received from a creditor is larger than necessary to cover the expense of claims, a portion of the premium is returned to the creditor. Thus, the higher the premium the higher the compensation to the creditor.
>
> Problems arise in the field of consumer credit insurance that do not occur in other lines of insurance because of a phenomenon termed "reverse competition." After a debtor has agreed to the terms of a sale or loan, the debtor is generally unwilling to shop around for credit insurance from someone other than the retailer or loan institution from which the purchase or loan has been obtained. As a result the insurers and creditors are able to change higher premiums with little protest from the consumers. The debtor is a captive audience for the creditor, and many times may think the credit insurance is a condition of the sale or loan. That environment plus methods of compensation to the creditors that are tied to higher premiums encourage higher premiums — thus the term reverse competition. (Emphasis added.) (Appendix 1, p. 2).

As the name suggests, the reverse competition that prevails in the credit insurance business turns market theory on its head. Underwriters lure lender institutions by providing commissions as high as state law allows — with commissions of 40 percent and higher being typical. Since the actual proportion of the borrower's installment payments attributed to credit insurance is relatively inconsequential, the consumer rarely complains; indeed amongst those borrowers aware of the fact that they have purchased credit insurance, most seem to regard it as a wise purchase. Yet, those who have objectively studied this practice, universally condemn the excessive premiums and profits generated by this business. According to the same NAIC report referenced above:

> Much of the criticism today of credit insurance is the profit margin of the credit insurance companies and the creditors. Many critics of credit insurance complain that premiums are unnaturally and unnecessarily high in credit insurance due to creditor compensation and incentives, which take various forms. (Emphasis added). (Appendix 1, p. 8).

This is further corroborated by the testimony of C. Donald Ainsworth, Director of the Missouri Division of Insurance, during a recent hearing in Missouri:

> For many years, the sale of credit life insurance and credit disability insurance has been the subject of significant controversy throughout the country. Because insurance is sold only in conjunction with extensions of credit and because the cost of the insurance is borne by the borrower (as opposed to absorbed by the lender as an overhead cost), insurance companies have competed with one another to elevate the price of the insurance in order to pay the lenders the highest possible commission. By keeping the premiums for credit life and disability insurance high, insurance underwriters have been able to pay lenders very generous commissions (historically sometimes as high as 70 to 80 percent) in order to induce these lenders to sell their credit insurance products rather than the credit insurance products of some other underwriter. The result of this so-called "reverse competition" has been that consumers have paid premiums for credit insurance out of all proportion to insurance company loss experiences. At the same time, lenders...have reaped enormous profits from the commissions paid on their credit insurance sales. (Appendix 3, p. 6).

The concept of "loss ratios" will be discussed in more detail below. It will suffice at this juncture to note that the loss ratio measures the percentage of premiums that actually go to the payment of claims. Thus, it is possible to use these figures to determine whether premiums and profits are unreasonable or excessive. In the context of credit life and credit disability they have been invariably high, with less than one third of the premium being paid out as losses.

It is useful to contrast this figure with the combined loss ratio of property/casualty insurance in general. In 1982 this stood at 109.6 and has increased to 110.9 in 1983. Simply put, the stiff competition in the insurance market place has lead to a situation where over 10 percent more is being paid out in claims than is being received in premiums. The fact that credit life and disability insurance generates three times the amount of premiums than it pays out in claims is tangible evidence of the existence of reverse competition.

As a consequence of the unique problems associated with the sale of credit insurance, several studies have been conducted by various State and Federal regulatory and enforcement agencies. While the findings, conclusions and recommendations of these studies are referenced throughout these comments, several observations should be made by way of background.

The NAIC has been formally studying the sale of credit insurance to consumers since the late 1940's and has issued reports and recommendations at regular intervals since that time. The following is a partial list of industry practices of which the NAIC has been most critical: (1) failure to make full disclosure of insurance coverage and costs to purchasers under sales finance contracts; (2) sale of excessive coverage at excessive premium rates; (3) failure to refund unearned premiums; and (4) the existence of "coercion" resulting from "the unequal bargaining position of the creditor and the debtor" which typically leads "to debtors believing they had to buy insurance from the creditor in order to obtain the loan or make the purchase." (Appendix 1).

As a result of their investigations, the NAIC has adopted model guidelines and regulations, that have been adopted to some degree by all the states. While these guidelines endeavor to address the issues of coercion, excessive premium rates, and non-disclosure of material information, the NAIC as well as individual commissioners concede that they have not been sufficiently successful in rooting out these abusive practices. (Appendix 2).

The Federal Trade Commission as well as the Federal Reserve Board have conducted studies specifically directed toward the sale of credit insurance by banking institutions in concert with the extension of consumer credit. While their conclusions have differed, with the FTC being far more critical, the underlying findings and data provide substantial evidence of consumer perceptions of a tie-in between their ability to obtain credit and the desirability of purchasing credit insurance from that banking institution. The findings, and conclusions of these studies as well as independent critiques are discussed in more detail below.

III. CURRENT ABUSES IN CONSUMER CREDIT INSURANCE

The proposed revision of 12 CFR 225.4(a)(10), according to the public notice, is based upon allegations by commentors, that the existing rate reduction requirement has "placed bank holding company providers of this service at a competitive disadvantage to other participants in the market and that no significant evidence of the potential adverse effects considered by the Board eleven years ago has come to light." 48 Fed. Reg. 228, p. 53126. As indicated above, the evidence conflicts with these allegations. There most decidedly has been, and continues to be "decreased or unfair competition," "conflicts of interest," "unsound banking practices," and other practices adverse to the public interest.

A. Credit Insurance and Competition

As alluded to above, the very nature of credit insurance provides distinct advantages to the lending institution. Thus even in those instances where the lending institution acts merely in the capacity of an agent, with no internal underwriting facility, the penetration rate is substantial. The Federal Reserve Board's own study released in October 1978, revealed that of those consumers who purchase credit insurance, 97.5 percent purchase it through the creditor institution. (Appendix 4, p. 29). The study endeavored to diminish the significance of that figure by suggesting that only 62.2 percent of all borrowers surveyed purchased credit insurance. (Appendix 4, p. 2).

To the neutral observer, that would appear to be a significant penetration rate by itself. The systematic manner in which subsequent commentaries diagnosed the misleading nature and that 62.2 percent figure increases its level of significance. Critiques prepared by the Federal Trade Commission and by Professor Emmett J. Vaughan, Partington Professor of Insurance at the University of Iowa, agreed in their conclusions that the 62.2 percent figure was erronesouly low and misleading.

According to the FTC's commentary, their own investigations found that penetration rates normally "range in the high 90's and often approach 100 percent." (Appendix 6, p. 2). The discrepancies between the FTC's data and the Board's data were explained by the commentaries to be based upon several factors.

One factor was that the Board's study included commerical loans and transactions in other areas in which "it is generally acknowledged that credit insurance coercion is non-existent" due to the more balanced bargaining position and knowledge on the part of the parties. Secondly, the voluntary nature of the survey combined with the fact that numerous respondents failed to supply any responses skewed the survey and "resulted in an invalid sample." (Appendix 6, p. 2).

Thirdly, and most significantly, a considerable proportion of the respondents were not aware of the fact that they had purchased credit insurance. According to the FTC, "a recent consumer study shows that almost 40 percent of the retail credit customers surveyed did not know they had credit insurance coverage when they, in fact, were being charged for it." (Appendix 6, p. 2).

It should be noted at this point that the only question in dispute here is whether the data gathered by the Board in its survey substantiated a conclusion that there was a direct and illegal tie-in. Whether the evidence leads one to that conclusion, or to the alternative conclusion that this was merely a function of convenience or efficiency is taken up below. The point that must be emphasized in the present context is that the mere fact that 97.5 percent of those borrowers who know that they had purchased credit insurance, admitted to purchasing the insurance from the creditor institution, demonstrates the extent to which that competition has "diminished."

That the competition provided by the lender institutions is also "unfair" is evidenced, in general, by the data on the tie-in phenomona discussed below, and specifically, by the testimony of third parties and of the lender institutions themselves. The appendix to these comments contains the testimony of several insurance agents as well as that of the Director of Missouri's Division of Insurance, relating their personal experiences with lender abuses in the sale of both credit and non-credit related insurance (Appendix 5). One illustration here will suffice. The following is excerpted from the statement of Ronald A. Ollis, principal of the Ollis & Company Insurance Agency in Springfield, Missouri during a recent hearing (Appendix 8).

> For many years, savings and loan associations in Missouri have been selling property and casualty insurance through their service corporations. My father got started in the insurance business by acting as an agent in Springfield for customers referred to him by United Savings & Loan Association, and S & L that was then headquartered in Lebanon Missouri. Eventually, United opened up its own insurance agency facility in Springfield. The United agency ended up writing all of the insurance that had previously been written for United borrowers by Ollis & Co., Inc. For a long time thereafter, its was extremely difficult for us to sell any homeowners insurance on new homes. In fact, to this day, the vast majority of the homeowners insurance accounts that we handle are on re-sales (as opposed to new homes) and on very expensive new dwellings that are not financed through S & L's. For many years now, almost all of the homeowners insurance that is sold on new development homes is sold by the savings and loan affiliated agencies. The savings and loans make the loans to purchase the homes and they see to it that they sell the insurance as well. It is very profitable for them.
>
> If we were given the opportunity, we could easily out-compete savings and loan affiliated insurance agencies, even on homeowners insurance. Savings and loans, however, have used all sorts of techniques to make it very difficult for a person who borrows money from them to buy his homeowners insurance from any other source...Over the years, I have had occasion to analyze a number of homeowners policies sold by insurance agency affiliates of savings and loan associations. Very often I have found that the insurance had been written based on the amount of the loan made by the savings and loan association, and not based on the insurable value of the home. The lender therefore was fully protected; the borrower, however, was not. On other occasions, I have found that I could provide the same or more insurance at a lower cost. Nevertheless, I have seldom been able to persuade an insured that he should switch his insurance coverage. (See Appendix 8, p. 19).

The testimony, based upon a series of typical experiences, portrays the blatantly "unfair" methods of competition engaged in by banking institutions in the sale of insurance products. These practices are not merely "unfair," but demonstrate how these institutions can effectively tie the sale of insurance to the extension of a loan. This is elaborated upon below.

B. Conflicts of Interest and Credit Insurance

Conflicts of interest are regularly exhibited by banking institutions in the context of the sale of credit insurance, and are manifested in four distinct ways: (1) Overt pressure upon loan officers to sell insurance products and to increase penetration rates, (2) Non-disclosure to borrowers of either the availability of alternative sources of insurance or of the effective rates, (3) Explicit or implicit tie-in practices leading to consumer perceptions of the purchase of insurance as a condition for the loan, and (4) Excessive profitmaking on the part of lending insitutions.

The following excerpts are verbatim quotations from officials of Commerce Bancshares, Inc. ("CBI"); a major Missouri bank holding company, to the chief executive officers of its subsidary banks. These documents were obtained during discovery proceedings in the context of litigation surrounding CBI's application to the Board to sell property/casualty insurance and can be found as Appendix 10. This is just a sampling.

> February 7, 1979
>
> Typically loan demand is somewhat slack during the month of January, but I noted penetration statistics were also down which would indicate in many cases that we were not producing up to our normal performance which proves once again "penetration is the key to success." When the penetration drops, so does our profit.
>
> It is imparitive (sic) that each of your commercial lenders submit an individual performance report on the 20th of each month as we intend to add another agent of the year award this year. It will be called "The Commerical Agent of the Year Award" based entirely on top dollar of level term sales.
>
> We are still making plans for our insurance recognition seminar to be held at the Lodge of the Four Seasons on May 4-6, 1979. Please advise your lenders who qualified to shine up their golf clubs, tennis racquests and to pack their swim trunks. (Appendix 10, p. 21).

> February 7, 1980
>
> As installment loan demand continues to decrease so does your insurance income. In order to offset this loss of income we must continue to improve our penetration of Level Term sales on single payment loans. As you are aware, most of your installment loan departments do a good job in the sale of our insurance products, but the commercial loan departments have not begun to penetrate their market. In fact, eight of our banks did not sell one Level Term policy last month. This market is an ideal source of additional income that will bring your bank sales back to a respectable dollar level. Remember, penetration of available loans is the key to our bank's insurance success and profits. (Emphasis added.) (Appendix 10, p. 3).

These excerpts make clear that the level of penetration weighs more prominently in the conduct of these institutions than does serving the best interest of their clients. All the major studies of credit insurance practices have produced evidence of a lack of full disclosure on the part of the lender institution to the consumer. The penetration figures are certainly strong circumstantial evidence that the consumer is not adequately alerted that he is not required to purchase credit insurance from the lender institution in order to obtain a loan.

The FTC and the NAIC have harshly criticized such abusive practices in the realm of non-disclosure. Since their initial investigation in 1949, the NAIC has consistently criticized "failure to make full disclosure of insurance coverage and costs to purchasers under sales finance contracts." This, combined with the excessive profits reaped by credit insurance undewriters, recently compelled Tennessee Insurance Commissioner John C. Neff to distribute a critical assessment of their product to all his fellow Commissioners, concluding that: "I think credit life is a cancer in the business of insurance." (Appendix 2, p. 1). As noted, the FTC has reported findings that anywhere from 12 and 40 percent of those purchasing credit insurance from lending institutions are unaware that they have in fact purchased this product.

Such findings of inadequate disclosure may be partially attributed to confusion. After all, the consumer is negotiating a loan and not an insurance contract. While this is no justification, it does suggest a possible explanation. However, there is no explanation that can mitigate against the practice of blateat misinformation. The FTC, in its enforcement activities, has confronted numerous instances of casual and systematic defiance of the law. They concluded that truth in lending requirements have failed:

> The problems we have encountered in the credit insurance area appear in no way alleviated by the present form of Regulation Z. That is, the present (disclosure) provisions of Section 226.4(a)(5) of Regulation Z do not ensure the voluntary selection of credit insurance since those creditors who wish to evade the intent of this section may do so by making disclosures that are in ostensible compliance with the Regulation, while orally informing or indicating to the consumer that the insurance is required. (Appendix 5, p. 11).

Some insurance commissioners view this type of practice as being so pervasive that they dismiss out hand the effectiveness any cosmetic regulations intended to promote truthful disclosure. C. Donald Ainsworth, Director of the Missouri Division of Insurance, concluded that: "...since most of the abuses that could occur...arise as a result of the combination of sales of insurance with extensions of credit, the only way to prevent abuses from occurring is to separate the sale of insurance from the loan transaction. That can most effectively be accomplished by leaving insurance to full-time, professional insurance agents and leaving banking to the bankers." (Appendix 3, p. 12). We would concur that some type of separation is required to ensure compliance. An arms-length relationship must be established that serves as a barrier to such blatant misrepresentation and coercion.

This opens up the controversial issue of the existence of a tie-in between the extension of credit and the sale of credit insurance. The FTC's critique of the effectiveness of Regulation Z, cited above, is based upon their familiarity with numerable instances in which a consumer is informed in writing of his freedom to reject credit insurance from the lender — and purchase it elsewhere — and immediately informed orally that insurance would be required. Such experiences are not merely anecdotal. The Federal Reserve Board's own 1978 survey demonstrates the systematic nature of this problem. (Appendix 4).

The figures are quite revealing. The Board found that 62.2 percent of those surveyed know that they have purchased credit insurance. Of this number, 97.5 percent purchased insurance from the lending institution. Over one quarter of the total number of consumers surveyed felt strong pressure from the lender to make this joint purchase. Specifically, 16.4 percent responded that the purchase was "required," while 8.8 percent were told it was strongly recommended, a total of 25.2 percent.

Considering the fact that in over one fourth of these transactions, the lender institution acted in direct violation of the anti-trust laws, as well as the Bank Holding Company Act, it is remarkable that the Board concluded that there was as "absence of coercion" and that:

> In conclusion, the analysis of the surveys suggests that explicit tying between the granting of credit and the sale of credit related insurance is practically non-existent and that implicit pressures brought by lenders on the borrowers are neither very strong nor widespread in the industry.

The staff of the FRB was apparently alone in drawing this conclusion from the data. The FTC was incredulous at the Board's conclusion of a "non-existent" tie-in and proclaimed that:

> We believe a 25 percent violation rate is not only significant but unacceptable. ...While the FRB study concludes that this is a "voluntary" purchase we believe that it is fundamentally involuntary and perceived by the consumer as a condition to obtaining the loan. This perception is tied to the lender's market power and is exactly the type of incipient violation of the anti-trust laws that the FTC has attacked in other contexts. (Appendix 6, p. 5).

Another analyst, Professor Emmmett J. Vaughan, thought that the FTC understated the flaw in the Board's conclusions. He would have added to the 25.2 percent who were told that credit insurance was "required" or "strongly recommended," the 25.7 percent who were told that this joint purchase was "recommended." His conclusion is explained as follows:

> A bank officer may merely "suggest" or "recommend" that the loan applicant consider purchasing life or disability insurance from the bank. This, it is suggested, would be a "convenient" way to reinforce the loan application. Quite naturally, the loan applicant may consider this "suggestion" to be a requirement that must be met to obtain the loan. Thus, customers perceive the implicit threat of deprivation of a needed banking service and submit to the recommendation to purchase the insurance. (Appendix 9, p. 6).

Thus, he would conclude that 50.9 percent of those surveyed perceived a real need to purchase credit insurance from the lending institution. Since 62.2 percent of those surveyed purchased insurance, we are left with the troubling, but inescapable conclusion that 88.7 percent of those surveyed purchased credit insurance as a direct consequence of strong and subtle — but in either case very real — pressures from the lending institution. As already noted, of those purchasing insurance, 97.5 percent purchased it from the lender at the time of the loan.

In the face of this type of evidence, the allegations of the commenters that "no significant evidence of the potential adverse effects considered by the Board eleven years ago has come to light," can be summarily disregarded. Non-disclosure and misrepresentation of material information and explicit and implicit tie-ins represent only part of the abusive practices to which consumers are subjected. As one might predict in the case of a captive audience, the cost of the credit insurance is excessive and unreasonable.

The non-competitive price structure of credit insurance was noted above in the context of the discussion of "reverse competition." There is also an empirical relationship between price and market coercion, with the willingness of consumers to complacently submit to price gouging being circumstantial evidence of a tie-in.

As noted above, credit insurance stands as an anomaly in the contemporary insurance market, where competition is so intense that property/casualty insurers are paying out ten percent more in claims than they are receiving in premiums. Figures released by the Tennessee insurance department, on the other hand show that in the area of credit life insurance, there was an overall loss ratio in 1982 of 33.5 percent. That is, for every dollar collected in premiums, only $.335 is paid out in claims. The NAIC recommends that the loss ratio in this area should be no less than 60 percent, with the difference between this figure and the lower, actual figure representing the amount of excess profits. (Appendix 2, p. 6).

Of course, the figure of 33.5 percent accounts for the loss ratio compiled by all creditors engaged in the sale of credit life in Tennessee. When broken out by type of creditor, the category captioned "commerical and savings banks" yield a loss ratio of 30.4 percent. (Appendix 2, p. 6). One would pressume that the mandatory rate reductions would translate into a higher than average loss ratio for banking institutions. Yet the banking institutions, on average, record a loss ratio 3.1 percent less than the all industry figure.

More striking, the category including multi-line insurance companies recorded a combined loss ratio in the area of credit life of 91 percent. The Traverlers Insurance Company had a loss ratio of 118 percent, Allstate recorded 77.6 percent, and First Pyramid 98.2 percent, etc. (Appendix 2, p. 4). And yet, "commenters" have alleged that bank holding companies suffer from a competitive disadvantage due to the mandatory rate reductions.

The reason for the market place discrepancy is not difficult to explain. Rate reductions are applied to prima facie rates, not market rates. The prima facie rates are the maximum statutory rates the State permits for a given line of insurance. When faced with intense marketplace competition commercial insurers must set premiums at a mcuh reduced rate.

Thus, for example, in Missouri, Commerce Bankshares, Inc., set credit life premium rates at $.58 per $100 of coverage, or 3.3 percent below the Missouri prima facie rate. On the other hand, Prudential Insurance Company's rate for credit life in Missouri was $.375 per $100 of coverage. The reason for this dramatic difference? Prudential had to compete with other insurers, CBI, because of its ability to tie credit to the sale of insurance, had no competition to worry about. (Appendix 11, p. 16).

To suggest, as commenters do that bank holding companies operate under a disadvantage vis-a-vis other providers, is untenable. These commenters, presumably, are distressed that FRB rules prohibit them from charging the public the maximum rate. This ought not represent a compelling argument for the Board to lift these reductions. Rather, it should motivate the Board to apply these rate reductions in a more effective manner so as to provide a real benefit to the public.

IV. CONCLUSIONS

The dual allegations that bank holding companies must operate at a "competitive disadvantage" and that there is a paucity of proof to demonstrate "adverse effects" upon the consumer, simply do not comport with the overwhelming evidence. The evidence gives rise to a diametrically opposite set of conclusions. Exploiting the consumer's perception of a tie-in between the extension of credit and the sale of credit insurance, bank holding companies in fact avail themselves of the competitive advantages that inure to the monopolist. In addition, the laundry list of anti-consumer practices disclosed above — such as non-disclosure of material information, grossly excessive prices, etc. — more than substantiates the Board's suspicion, eleven years ago, that there was a real potential for adverse effects upon the consumer. Thus, we reiterate our recommendations.

First, we would urge the Board to establish effective rate reductions. The current requirement of making a minimal set-off against prima facie rates simply does not represent a real public benefit. It is a placebo. Rather, a rate reduction should be applied to the going market rate to meet the net public benefit test.

Secondly, to address the ongoing criticism that there is a lack of full disclosure made to the borrower, we would suggest that the lender be required to disclose all material information with respect to the cost, coverage and availability of insurance.

Thirdly, to attempt to ameliorate the consumer's perception of a tie-in, we would recommend, at a minimum, that loan officers be prohibited from being involved in the sale of insurance. This would lessen the possibility, for example, of the insurance papers being shuffled in among the paperwork related to the extension of credit.

We believe that, taken together, these three recommendations would more effectively comply with Congressional intent in establishing a net public benefits test.

Respectfully Submitted:

Lawrence R. Herman
Director of Congressional Relations
for The Independent Insurance
Agents of America, Inc.

APPENDICES

1. Memorandum To NAIC Task Force on Credit Life Insurance and Credit Accident and Health Insurance: 12/7/83.

2. Memorandum to Commissoners of the NAIC by Tennessee Insurance Commissionor John C. Neff: 11/9/83.

3. Statement of Missouri Insurance Commissionor C. Donald Ainsworth Before the Board of Governors of the Federal Reserve System, in the Matter of Mercantile Bancorporation, Inc, and Commerce Bancshares, Inc.

4. Study of Tie-Ins Between the Granting of Credit and Sales of Insurance By Bank Holding Companies and other Lenders, By the Staff of the Federal Reserve Board: 1978.

5. Summary and Paper By Emmett J. Vaughan, Ph.D. CPCU: The Federal Reserve Boards Tying Study: A Critical Analysis, March 1979.

6. Letter to Senator William Proxmire from the Federal Trade Commission, in Critique of the Federal Reserve Board's Tying Study, Feb. 1979.

7. Letter to Attorney C. Lee Peeler from the Comptroller of the Currency Concerning the Federal Reserve Board Tying Study, Feb., 1979.

8. Statement of Ronald A. Ollis Before the Board of Governors of the Federal Reserve System in the Matter of Mercantile Bancorporation, Inc. and Commerce Bancshares, Inc.

9. Excerpts from Sworn Testimony of IIAA Witnesses: Applications of Mercantile Bancorporations, Inc., and Commerce Bancshares, Inc., for Authority to Engage in Property and Casualty Insurance Activites, June 20, 1983.

10. Memorandum on Tie-Ins Between Sales of Insurance Extensions of Credit - Commerce Bancshares, Inc., Oct. 5, 1982.

11. Petition: IIAA v. Board of Governors of the Federal Reserve System and Commerce Bancshares, Inc., and Mercantile Bancorporations, Inc.: Reply Brief of Petitioners: 12/21/83.

STATEMENT OF HARRY F. CUSTIS, CLU, CPCU, MEMBER, LEGISLATIVE COMMITTEE; CHAIRMAN, PROFESSIONAL LIABILITY SUBCOMMITTEE, NATIONAL ASSOCIATION OF CASUALTY AND SURETY AGENTS; PRESIDENT, CORPORATE INSURANCE MANAGEMENT, INC., WASHINGTON, D.C.

I. INTRODUCTION

Mr. Chairman and members of the Senate Banking, Housing and Urban Affairs Committee, my name is Harry F. Custis, CLU. I am President of Corporate Insurance Management in Washington, D.C. and am a member of the National Association of Casualty and Surety Agents (NACSA), a national association representing 255 of the leading commercial insurance agencies and brokerage firms throughout the United States and Puerto Rico. As a member of NACSA, I sit on NACSA's Legislative Committee and serve as a subcommittee chairman for this committee.

I am pleased today to have the privilege to appear before the Senate Banking, Housing and Urban Affairs Committee and to represent NACSA on the complex and controversial issue of financial services deregulation. The following written remarks will address the broad issue of financial services deregulation and more specifically, S. 2181, the "Financial Services Competitive Equity Act," and S. 2134, the "Depository Institutions Holding Company Act Amendments of 1983." I would appreciate your incorporating this written statement in its entirety into the hearing record of your committee.

II. AN OVERVIEW ON THE LEGISLATIVE HISTORY OF EXPANDED POWERS FOR BANKS

A. Role of Congress

Since the great depression of 1929 and the enactment of the Glass-Steagall Act of 1933, congressional action and intent have continued to support a separation between banking and commerce. The privilege of a bank charter has been carefully balanced with an awesome public responsibility, namely the safeguarding of bank deposits and the overall solvency of the banking institution. As a consequence, Congress has approached conservatively the expansion of bank authorities and the loosening of bank regulatory supervision. We applaud Congress on this approach. Bank solvency and the special role banks play in the United States and in the world economy can never be underestimated. Congress must continue to proceed with caution.

NACSA agrees wholeheartedly with this committee that it is the sole responsibility of Congress to determine national bank policy. Congress must decide, as it did in 1933, whether the role of banks has in fact changed; and if it has changed, whether the new role is appropriate for banks. Society places the ultimate burden of decision on Congress, but in the long run, the burden is placed back on society for the resolve of Congress profoundly affects each and every one of us as consumers and as businesspeople.

B. An Historic Perspective

In 1956 Congress adopted the Bank Holding Company Act (BHC Act) to better control and supervise the interaction between banks and their non-banking affiliates. Congress observed that the non-bank activities of banks were putting into jeopardy the banking institution itself. Once Congress recognized the problem, it restated the intent of the traditional separation between banking and other forms of commerce by enacting the BHC Act.

Within a short period of time, a loophole in the 1956 Act was exploited by bank holding companies which determined the Act, as written, only applied to multi-bank holding companies. Thus, one-bank holding companies began to spring up in great numbers; affiliations between a bank and non-banking institutions was once again a problem. Congress neither overlooked nor endorsed this activity; rather, in 1970, the one-bank holding companies were incorporated into the BHC Act. The intent of Congress was to both preserve the uniqueness of the bank charter and to serve the consumer as best it could in the process. The point here is indeed that Congress took note of specific market forces at the time and observed definite changes in affiliation and service.

However, Congress did not simply rubber stamp these new activities or rewrite federal law to incorporate them. Rather, Congress studied hard the market situation and the intent of Congress in regulating banks, and in its wisdom, Congress then decided to strengthen its original convictions, not weaken them.

Since 1970, banking institutions have not once relented in their quest to expand their non-banking authorities. More specifically, at both the federal and state levels banks have tried to enter, both directly and indirectly, the insurance business. The large bank holding companies, disgruntled by federal prohibitions and Federal Reserve Board red tape, have pushed the hardest.

As is appropriate, Congress has restudied the issue on numerous occasions. In the 95th and 96th Congresses, the House of Representatives actually adopted an amendment to the BHC Act which strictly limited the insurance activities of BHC's. To the insurance industry's dismay, the amendment was not finally enacted into law during either Congress. However, because of the perseverance of insurance agents and brokers and other supportive interest groups, Congress did enact a similar amendment to the BHC Act at the end of the 97th Congress. The amendment, Title VI of the Garn-St Germain Act of 1982, specifically amended Section 4(c)(8) of the Act to limit the insurance activities of BHC's.

Title VI was a conscious act by Congress to curtail expanded insurance activities by BHC's, all of which were deemed not in the best interest of the bank or the consumer. Contrary to the views of its critics, Title VI was adopted on its merits and is law today because Congress determined it was appropriate and necessary to separate banking from the sale and underwriting of most types of insurance. Bank credit leverage and bank solvency are just two compelling reasons why Congress enacted this title.

General prohibition and exemptions (of Title VI)

> *Title VI generally prohibits a bank holding company from providing insurance as a principal, agent or broker. There are six exemptions to this general prohibition, resulting in the prohibition being principally applicable to the underwriting or sale of property and casualty insurance products. The exemptions establish a grandfather date for the continuation of previously authorized insurance activities, such as selling credit related property and casualty coverages, and permit bank holding companies to engage in, among other things, credit life, disability, and involuntary unemployment insurance activities and general insurance agency activities in towns of less than 5,000 people. (S.Rpt. No 97-536)*

C. A Regulatory Outlook On Title VI

In January 1984, congressional intent was reinforced by the Federal Reserve Board's decision to suspend consideration of applications by Citicorp, First Interstate Bancorp and Bank of America to acquire South Dakota state chartered banks for the purpose of entering all facets of the insurance business. The Board could not in all conscience approve these applications since such an endorsement would have both aborted the true meaning and intent of the BHC Act and in effect, would have made the Board itself an impotent federal regulator of national bank policy. During its recent deliberations, the Federal Reserve Board recognized that the clear intent of Congress is for the Board to consider not only actual abuse of economic power, but also the potential for such abuse. The South Dakota applications on their face appeared to be simple bank acquisitions, but after further study, the Board realized they were in fact a direct attempt to circumvent congressional intent and the BHC Act.

III. CHANGES SINCE ENACTMENT OF THE GARN-ST GERMAIN ACT OF 1982

A. Creditor Versus Insurance Producer Outlook

The rationale of opponents of Title VI continues to be that since 1982, market forces and rapid change in technology have outdated much of the Garn-St Germain Act.

In fact, they go so far as to say that Title VI is both an anachronism and a barrier to fair and effective delivery of service to bank customers. They want not only to repeal Title VI but to go beyond that and get into other services to offer (what they claim to be consumer driven) the "bundling" of financial services.

NACSA does not agree with the perspective outlined above. NACSA members recognize that many changes have occurred; nonetheless, they do not believe these changes have in any way either depreciated the value of or nullified the need for the separation between banking and insurance as envisioned by Congress in 1982. Also, NACSA members have yet to hear an outcry from their insureds that they need a new insurance delivery system through their banks.

Further, the Association of Bank Holding Companies would have us believe that the sale of credit and insurance as a bundled package is no different than the bundling of a data processor and the supplies needed to operate the equipment. The message delivered in "The Role of Bundling In The Provision Of Financial Services" is: just as technological change and market forces have brought about the modern phenomenon of the large supermarket and has bundled the sale of data processing equipment and supplies, so too have market forces and technology made antiquated the insurance industry's delivery system, the American Agency System (AAS). NACSA strongly refutes this conclusion. There is no validity to the comparison of the bundling of data processing equipment and supplies with the bundling of credit and insurance.

Credit leverage is fact, not fiction. Credit is not a product that is readily available to all comers as are computers and vacuum cleaners. A consumer must qualify for credit, and in reality, almost all credit transactions are secured by a financial guarantee, insurance. This fact by itself makes insurance unique within the setting of a credit transaction.

Creditor's leverage and the credit tie-in, whether explicit or implied, are facts of life, especially in relation to the sale of insurance. A creditor cannot remove the human variable from the business transaction; Congress cannot, in truth, legislate it away either. A consumer's perception and his desire for credit may often drive the tie-in sale more than the creditor himself. Nonetheless, the effect is the same, a credit tie-in sale; this indeed creates an unfair competitive advantage for creditors who alone have this leverage. Ultimately this is a disservice to the consumer.

B. What In Fact Has Changed

What has occurred since 1982 is: 1) certain non-banking institutions have taken full advantage of a loophole in the BHC Act; 2) the technology of home computers and electronic transfers has advanced rapidly; 3) BHC's want to take advantage of their access to customers and their customer base by offering non-bank services; and 4) states have been searching for quick and easy avenues to new employment and increased revenues.

Further, a perception has been created by the large BHC's that these changes are consumer driven,and the best way to remedy this market situation and its inequities is to: 1) expand BHC powers, 2) rubber stamp the other market changes, and 3) rewrite the laws in accordance with these changes.

This perception has been passed on to a broader audience than in the past. The idea behind the BHC's creation seems to be that the longer this perception lingers, the sooner these changes will be viewed as "inevitable." NACSA recognizes the inherent dangers in this approach and once again, cautions Congress to study the issue well beyond its surface.

In NACSA's opinion, change is inevitable, but what is changed makes a world of difference for business and the consumer. One of the primary goals of financial institution regulation must continue to be both to preserve the safety and soundness of our financial institutions and to safeguard the public interest and fair competition.

IV. A LOOK AT S. 2181, THE "FINANCIAL SERVICES COMPETITIVE EQUITY ACT," AND S. 2134, THE "DEPOSITORY INSTITUTIONS HOLDING COMPANY ACT AMENDMENTS OF 1983."

A. An Overview

A general examination of both S. 2181 and S. 2134 reveals that the proposals are bankexpanded powers bills, one more expansive, however, than the other. NACSA, both philosophically and practically, opposes these two proposals on the grounds that bank authority should not be expanded. NACSA's primary reasons are: 1) the unique role of banking, [illegible] credit leverage, and 3) the recent increase in bank failures. Very little has occurred since 1933 to give Congress reason to abandon the underlying philosophy behind the national bank policy of the separation between banking and commerce.

Moveover, the recent experience of the Butcher banks in Tennessee, the overextension of credit to foreign countries by the large BHC's, the abuse of credit leverage in the sale of credit insurance as documented in a recent filing with the Federal Reserve Board, and the Wisconsin Thorp Financial Corporation restraining order, to name a few, give Congress just cause to proceed with caution rather than to settle for the perceived "inevitable."

B. Specifics

1. S. 2181, The "Financial Services Competitive Equity Act"
   - a. NACSA opposes expanded insurance authority for BHC's. Title VI should not be repealed. Title VI was adopted in the public interest and is as valid today as it was in 1982.
   - b. It is not in the public's interest, both for reasons of fair competition and of safeguarding bank solvency, to eliminate the application/hearing

procedure and public interest test. Uncurtailed and unreviewed entry of banks into any non-bank service is not sound banking policy whether or not the service is provided through a non-bank subsidiary of a holding company.

c. The BHC Act is national bank policy. The BHC Act should apply equally to all BHC affiliates; no distinction should be made for the intrastate activities of affiliated state chartered banks.

d. NACSA believes Section 107 is an honorable attempt at providing consumer protections for the sale of insurance. However, written disclosures, first of all, have proven to be ineffective in protecting the consumer during a pressured transaction situation. Truth-in-lending credit insurance disclosures and resulting market penetration substantiate this judgment. Also, the 1979 Federal Reserve Board study, "A Study of Tie-Ins Between the Granting of Credit and Sales of Insurance By Bank Holding Companies and Other Lenders," showed that consumers were often unaware of their purchase.

Secondly, a right of injunctive relief is, in effect, unworkable since the consumer has to be aware of the abuse and then take the necessary steps to have the abusive activity stayed.

Thirdly, a 30-day right to rescind is fine in theory but unrealistic in practice for the sale of insurance. Credit leverage does not promote shopping around, and consumers are unlikely to rethink their insurance purchase after the transaction has been completed. Unlike a tangible product, insurance does not readily come to mind again until the renewal date.

Overall, Section 107's primary limitation is that Congress cannot legislate away the human factor in a credit transaction. In many other respects, Section 107 is just unrealistic and unenforceable.

e. NACSA cannot understand the reasoning behind the consumer bank exemption. The consumer bank provisions in S. 2181 create a large loophole in the BHC Act and go to the heart of the safety and soundness issue. Personal loan activities and deposits should be as well protected as commercial transactions.

In some respects, the consumer is more vulnerable than is the commercial enterprise. In light of all the recent concerns over the non-bank bank, it is unreasonable to create a legitimate loophole under which these entities may operate.

2. S. 2134, The "Depository Institutions Holding Company Act Amendments of 1983"

a. NACSA's general observation is that S. 2134 is a limited expanded bank powers bill, and as previously noted, we oppose expanding bank powers. We are pleased, however, that S. 2134 does not expand the insurance authority of BHC's and preserves Title VI of the "Garn-St Germain Act."

b. Section 14 of S. 2134 is troubling since it would permit state chartered bank affiliates of BHC's to perform activities in their state which are not authorized by the BHC Act if the state chartered bank's state law permitted such activities. This provision attacks the very heart of national bank policy and in effect, circumvents the authority of the BHC Act. We earnestly believe this was never envisioned by Congress, and we therefore, strongly oppose this provision.

V. CONCLUSION

NACSA believes that Congress must examine whether this trend towards large, financial conglomerates is appropriate, if it really serves the public well, and if its ultimate impact is in fact going to be pro-competitive. NACSA is not convinced that this is the direction in which we should be headed, for it will have an adverse impact on the consumer and on small business.

NACSA members do not think current market and legislative trends are in the public's interest. In the long run, we do not believe the insurance consumer or the commercial buyer will benefit, and we think the ultimate outcome will be anti-competitive, particularly for commercial enterprises in need of a variety of financial services. If current trends continue, NACSA predicts the following:

1) the drying up of the small-to-medium sized financial service organizations (a direct result of unfair competition);
2) a limitation on consumer and commercial buyer choice (on the availability of products and services);
3) impersonalization and standardization of products and services; and
4) a concentration of power in a few large financial institutions and in a few geographic areas.

The strengths of the AAS are professional service and consumer choice. Agents, otherwise known as insurance producers, are educated insurance professionals and experts. They are specially trained to serve the diverse needs of the insurance consumer. Of particular importance to consumers are not only the insurance product and its price (the policy and its premium), but also the service that is behind the product. From my experience the independent agent services the insurance consumer far better than any other provider. It is the agent's business to serve and to know how to get accurate information and a speedy resolution to consumer claims.

As to consumer choice, it is only in the AAS that consumer needs and in particular, consumer uniquities can be best served. Independent agents have access to many insurance markets and can search out the policy that best fits the needs of the particular client. The AAS also permits shopping around for this product at the best price.

It is our opinion that large financial conglomerates and the emerging trend toward the commingling of banking and insurance services threaten the very survival of the AAS. The stranglehold depository institutions have on depositors and the potential tie-ins between credit and other financial services create an unfair competitive advantage for the deposit-taking financial institutions. Independent agents and brokers have no fear of fair competition. They live under fierce market competition right now. What they do fear, however, is unfair competition which will either squeeze them out of the market or force them to make undesirable business choices. The undesirable in our opinion would be to sell out the AAS to the banks and S&L's, putting an end to the system which has served America well.

Additionally, entering into businesses such as the underwriting and the sale of insurance could put at risk the money of depositors, and the losses incurred could force higher interest rates, higher charges for other services, and even bank or insurer insolvencies.

NACSA firmly believes it is only through the survival of the AAS that consumer choice and superior insurance service will continue. Again, we thank you for this opportunity to share NACSA's views with this committee.

STATEMENT OF J. KNOX HILLMAN, JR., CHAIRMAN, GOVERNMENT AFFAIRS COMMITTEE, PROFESSIONAL INSURANCE AGENTS; SHUFORD INSURANCE AGENCY, CONCORD, N.C.

The following statement is submitted to the Senate Committee on Banking, Housing, and Urban Affairs by the National Association of Professional Insurance Agents (PIA).

PIA is a national trade association representing more than 40,000 independent property and casualty insurance agents in all 50 States, the District of Columbia, Puerto Rico and the U.S. Virgin Islands.

PIA is concerned about the continuing efforts of bank holding companies (BHCs) and other depository institutions to get further involved in the business of insurance. We have voiced our opposition to BHCs and the savings and loan (S&L) industry underwriting and selling insurance to Congressional Banking Committees whenever an opportunity has presented itself since the 91st Congress. We therefore welcome this opportunity to appear before the Committee today as part of the insurance producers witness panel.

PIA opposes S.2181, the Financial Services Competitive Equity Act, and S.2134, the Depository Institutions Holding Company Act Amendments of 1983. This statement will set forth our reasons for this position.

Both bills, especially S.2181, would let banking and other regulated depository institutions get back into the business of engaging in a broad range of commercial activities that are currently prohibited by law. Banks once freely participated in the business of insurance, securities sales and investment banking, a broad range of real estate activities and many other speculative business ventures. Up until the early 1930s, banks, and their many business endeavors, were generally viewed as simply another form of diversified commercial enterprise in a complex and growing economy. Than came the bank failures and market crash that ushered in the Great Depression and the Congress began to analyze this crisis situation to determine what had precipitated this economic debacle.

One of the main lessons learned was that the safety and soundness of the existing banking structure had been seriously jeopardized by internal self-dealing and subsidiary stock purchases, financing speculative ventures, bailing out failing subsidiary non-banking endeavors with depositor funds, and a number of related improprieties. The end result of this extensive Congressional probing was a major new legislative thrust to correct these many abuses and prevent their re-occurrence by the enactment of strong laws restricting banks from engaging in general commerce, insuring the accounts of depositors, making the Fed the lender of last resort and assuring the public that the banking industry was generally backed by the full faith and credit of the United States. The goal was to protect the depositing and borrowing public and the banking industry itself from unsound banking practices.

PIA believes that laws, restricting federally insured and regulated depository institutions from engaging in a broad range of commercial ventures, have served this nation well by restoring and maintaining public confidence in such institutions.

It is, therefore, disturbing that the bills being considered today appear to be an effort by major banking institutions and their allies to return to yesteryear and again allow banks to engage in the same activity areas that helped precipitate the aforementioned banking crisis. We would hope that all Members of the Committee would, therefore, seriously reflect on this legislation by placing it in an historical context. May we respectfully suggest that there is considerable merit to that old adage that goes something to the effect that ... those who fail to learn the lessons of history may make the same mistakes.

No one can now doubt that banking and thrift institutions are indeed special and serve a number of important public policy purposes. They are not just another commercial enterprise. To accomplish these public policy goals, they are imbued with special lending and money supply powers, special tax advantages, and the full backing of the Federal Government. The importance of banking to the economy was well-stated by the Supreme Court in the case of United States v. Philadelphia National Bank:

> "Commercial banks are unique among financial institutions in that they are alone permitted by law to accept demand deposits. This distinctive power gives commercial banking a key role in the national economy. For banks do not merely deal in, but are actually a source of, money and credit; when a bank makes a loan by crediting the borrower's demand deposit account, it augments the Nation's credit supply. Furthermore, the power to accept demand deposits makes banks the intermediaries in most financial transactions (since transfers of substantial moneys are almost always by check rather than by cash), and, concommitantly, the

> repositories of very substantial individual and corporate funds. The banks' use of these funds is conditioned by the fact that their working capital consists very largely of demand deposits, which makes liquidity the guiding principle of bank lending and investing; thus it is that banks are the chief source of the country's short term business credit." 1/

While other institutions, in addition to commercial banks, can now accept demand deposits, banks alone are still the only institutions that can do so without major restrictions. Consequently, banks hold the overwhelming majority of demand deposits nationwide. 2/

Commercial banks usually serve all types of borrowers because they can make commercial, business, consumer, and mortgage loans. Banks also aid government tax collection efforts, invest in selected government securities, and have a significant impact on international money markets.

Major banking institutions contend that they need the powers contained in S.2181 to get back into the general insurance, securities and real estate business because they cannot compete with other providers of financial services. Now, the obvious implication of their lobbying effort is that if they don't get their way, they may soon be in trouble. This, however, does not appear to be the case.

1/ 374 U.S. 321, 326 (1962)

2/ Board of Governors of the Federal Reserve System, Federal Reserve Statistical Release, Money Stock Measures and Liquidity (Dec. 27, 1982).

A July 2, 1983 article in the NATIONAL JOURNAL points out that,[3]

> "For all the inroads into the banking business, the competitive position of banks in the financial services industry has not changed as much as is commonly thought, according to researchers at the Federal Reserve Bank of Chicago."

Indeed, banks appear to be holding their own,

> "According to the Chicago Fed, commercial banks held 38.2 per cent of all private financial assets in 1960, 37.9 per cent in 1970 and 36.5 per cent at the end of 1981. In 1960, 31.8 per cent of fulltime employees in the financial sector worked for banks; at the end of 1979, that figure had increased to 37.2 per cent."
>
> ""On balance," concluded the Fed economists, banks' gains "have roughly offset their losses, leaving their aggregate share of the financial services market unchanged.""

Although the banks financial services' competitors have been gaining strength over the last decade, their success has had little, if any, adverse impact on the banking industry. Indeed, CitiCorp and the other major bank holding companies that are promoting S.2181, all seem to be economically successful business concerns, controlling very profitable banks. None of them appear to be even remotely in danger of going belly-up if S.2181 is not enacted. PIA can, therefore, only conclude that their motivation to support this legislation and the Administration's earlier FIDA proposal can only be the result of more basic predatory and expansionist instincts.

[3] "Congress Is Hesitant About Moving to End Financial Industry Turmoil," National Journal, pp. 1372-1378.

Proponents of S.2181 suggest that banking problems and improprieties of the 1920s can be avoided by requiring that the bill's expanded powers for depository institutions be conducted by subsidiaries of the holding company, by placing limits on the amount of capital the financial institution can invest in such activies and their subsidiaries, controlling fund transfers between the financial institution and a subsidiary, and by limiting the size of the companies and financial institutions that can acquire each other. The idea here is that some sort of a barrier of sufficient magnitude can be statutorially constructed to insulate one part of the holding company entity from the economic fate of the other part's. The Chairman of the Board of Governors of the Federal Reserve System, The Honorable Paul A. Volcker, spoke to this issue in his testimony before this Committee on September 13, 1983, as follows:

> "1. We should continue to recognize that banks, and depository institutions generally, perform a unique and critical role in the financial system and the economy -- as operators of the payments system, as custodians of the bulk of liquid savings, as essential suppliers of credit, and as a link between monetary policy and the economy.
>
> 2. This unique role implies continuing governmental concerns -- concerns that may be reflected both in the support provided by lender of last resort and deposit insurance facilities and by regulatory protection against undue risk or bias in the credit-decision process.
>
> 3. A bank or depository institution cannot be wholly insulated from the fortunes of its

> affiliates -- their success or failure or their business objectives." (emphasis added)
>
> For instance, they underlie the strong tradition in the United States of a separation between banking and commerce, although the precise line between the two needs to be re-examined in the light of changes in technology and other factors."

factors."

PIA believes that,as a practical matter, a parent corporation cannot be insulated from the economic fate of its subsidiaries and vice versa. For better or worse, they are linked together and the adversities of one become the serious problems of the whole. They ultimately swim or sink together. This fact is amply illustrated by the Baldwin-United case and the Butcher Bank empire failures.

Banking interests argue that they need legislative relief to establish what has generally become known as the "level playing field" so that they can compete on an equal basis with other financial service providers. At first blush, this philosophically appears to be a reasonable, fair approach. In reality, however, the "level playing field" is a sham, a myth, a public relations gimmick because such a thing does not exist, nor can it ever exist within this context because of the unique, advantageous position enjoyed by federally regulated and insured depository institutions.

Banking organizations and other regulated depository institutions have an inherent competitive advantage because they alone can extend credit based on demand deposits, and their financial depositors' accounts are federally insured up to $100,000. They can utilize the Fed's discount window, rely on the Government as lender of last resort and ultimately fall back on the full faith and credit of the United States. To the perception of the average citizen, conducting business with such an organization and its affiliates is an activity protected by the Federal Government, any legal realities to the contrary notwithstanding.

Consider what happened when the Garn-St Germain Act granted banks and savings and loans (S&Ls) the right to offer money market mutual funds so that they could compete with the private offerings of such products. Well, for some reason, said legislation provided that bank and S&L money market offerings would be covered by Federal Deposit Insurance Corporation (FDIC) insurance. One need only turn on the TV to see bank and savings and loan advertisements offering such products that stress that their funds are backed by the FDIC and that those of their private sector competitors are not. The result has been a substantial dollar volume shift over to the bank and savings and loan accounts by people who previously did business with private offerers. Can anyone seriously argue that there is now a "level playing field" in this market? The banks and S&Ls have gained a major competitive advantage that they are taking advantage of to the fullest extent possible.

Indeed, the ability to extend and create credit gives depository institutions tremendous potential leverage that can and will be used to promote, expicitly or implicitly, doing business with said institution and its holding company affiliates for whatever products they may offer.

The credit tie-in would be especially applicable if BHCs were allowed to offer general insurance coverages as agent, broker and underwriter. Insurance is an essential part of the overwhelming majority of credit transactions because it is used, in almost all lending transactions, to protect the creditor by insuring repayment in the event of the borrower's death, ill health, unemployment or casualty to the property involved.

The argument has been advanced by the Association of Bank Holding Companies, as well as others, that product tie-ins have existed since the beginnings of commerce. We do not question this statement. However, it is necessary to realize that the relationship between credit and insurance is unique. All other product tie-ins are based on a financial incentive to the buyer. If you buy a home from Caldwell Banker, you can secure a discount from Sears on your carpeting. However, the sale of the house is not dependent upon your purchase of the carpet. Conversely, a house loan can not be secured until the borrower has presented the required insurance. It is this unique interdependency of credit and insurance that makes all other product tie-in examples inappropriate.

The lending institution need only suggest that its affiliate has the necessary insurance for sale and the tie-in, as a practical matter, has been made. The implication need only be conveyed to the borrower that it would be a good idea to let the lender handle all aspects of the transaction (including insurance) for obtaining the loan. The same rationale applies to commercial loans and related business insurance coverages.

We must never forget that in such situations the parties involved do not have equal bargaining power. The average personal or business borrower goes to see his banker, hat in hand, to obtain credit that is usually needed at that point in time and is considered essential. Such borrowers will go along with anything within reason suggested by the lending officer, even if they know they can shop around and get a better price and service for the same or better insurance coverage in the outside competitive insurance market. Their prime concern is obtaining and protecting that line of credit.

This point is clearly illustrated by the Regulation Y filing to the Federal Reserve made by the Insurance Producers Coalition, documenting the abuses of banks in their credit life insurance activities. Copies of this filing have been made available to each Member of the Committee and PIA strongly recommends that this evidence exposing blatant credit insurance tie-in abuses be carefully studied.

Indeed, what is the first question asked by any banker when someone goes to obtain a loan? -- "Do you have an account with this institution?" A BHC need only inform its customers and the public that it is in the general insurance business for consumers to conclude that by purchasing insurance from their bank's affiliate this may, indeed, help secure a line of credit when and as needed. Insurance price, product and service are not as important as enhancing one's position to obtain credit.

In the aforementioned situations, independent insurance agents are precluded from even competing for this business because of credit leverage. After careful analysis, the "level playing field" the bankers want does not appear very level, but is slanted very much in their favor.

In terms of specific sections of S.2181 and S.2134, PIA makes the following observations:

Subsection 104(a) of S.2181 purports to close the so-called "non-bank bank" loophole by bringing many of the federally insured non-bank banks under the jurisdiction of the BHC Act. It, nonetheless, creates another loophole in Subsction 104(a)(1) by exempting "consumer banks" created by Subsection 104(a)(2). It appears that said "consumer banks" can engage in a broad range of small business activities as long as they do not make commercial loans. PIA fears that the "consumer bank" exemption may provide opportunities for such entities to engage in the insurance agency business.

There is also the related problem of providing FDIC coverage to consumer banks because PIA does not believe that the Federal Deposit Insurance mechanism should be used to support the unregulated non-banking activities engaged in by such entitites.

Subsection 104(d) of S.2181 would amend Subsection 4(c) of the BHC Act to permit BHCs, after providing the Fed with 60 days advance notice, subject to Fed disapproval to engage in "insurance underwriting or brokerage," subject to no general limitation on the extent to which BHCs directly, or through a subsidiary, can engage in insurance activities. This provision is totally unacceptable to PIA because it repeals Title VI of the Garn-St Germain Act. It, alone, makes S.2181 unsupportable.

Section 4(c)(8) of the BHC Act currently requires that for a BHC to obtain Fed approval to engage in additional activities, the proposed activity must be "so closely related to banking or managing or controlling banks as to be a proper incident thereto." The Fed is also required to consider whether the activity will produce public benefits such as increased convenience, competition or efficiency that would outweigh adverse impacts like undue concentration, unfair competition, unsound banking practices or conflicts of interest.

Subsection 104(d) of S.2181 would change the Section 4(c)(8) test by eliminating the public benefits portion thereof and adding a new provision, providing that activities can be approved by the Fed if they are determined "to be of a financial nature." The Fed must publish a list of approved activities under the new test within 180 days of the effective date of this enactment and continually update and expand said list to add new services that can be offered by BHCs to improve competition.

This revised Section 4(c)(8) approach leaves the decision, as to whether or not an activity would expand competition, up to the Fed. It precludes the opportunity provided under current procedures for interested parties to object or petition for a full administrative hearing on the issue. PIA objects to this new procedure because it precludes public input in the name of administrative simplification.

Currently, S&Ls are prohibited from directly engaging in general insurance activities but their service corporations can freely sell insurance. Unitary S&L holding companies (S&LHCS) can function as agents for all types of insurance.

Subsection 104(d) also authorizes BHCs to acquire thrift institutions. Since the thrift industry already has substantial general insurance authority, this provision would provide another approach for BHCs to get further into the insurance business via a less direct route.

Subsection 104(f) of S.2181 adds an exemption to Section 4 of the BHC Act that permits BHCs to acquire shares of a company engaged in any activities authorized for multiple S&LHCs on, or prior to, July 1, 1983. This would provide BHCs another open invitation to get into the insurance agency business, even if the insurance provisions of Subsection 104(d) were deleted.

What is really needed in this area are additional amendments to the laws covering the S&L industry to make the insurance restrictions of Title VI applicable to them also because the credit leverage/insurance tie-in rationale supporting Title VI is equally applicable to the thrift industry. This is especially true now that thrifts have become more like commercial banks under the provisions of Garn-St Germain.

S.2134 contains no express provision like the aforementioned Subsection 104(d). It does, however, eliminate the "proper incident thereto" clause from the current Section 4(c)(8) BHC Act tests. This approach cannot be supported because it would remove the basis on which the Fed has previously denied BHC applications to acquire S&Ls.

Subsection 104(d) of S.2181 would add a new paragraph "C" to a revised Subsection 4(c)(8) of the BHC Act which is designed to prevent undesirable levels of economic concentration of financial resources. It bars BHCs controlling banks with deposits equal to or greater than .30% of all domestic deposits from merging with or acquiring a company engaged in insurance or other permissible activities if such merger or acquisition would result in that BHC having over 25% of its capital invested in any of these newly permissible activities. It would apply the same test to financial service companies that want to acquire or merge with a BHC. It is suggested that this approach will limit the affiliation between large insurance and other financial service companies and the 25 largest BHCs. From PIA's frame of reference, this is indeed an admission that there will be problems of economic concentration and related abuses if S.2181 is enacted. This provision is weak because it does not limit internal growth after such mergers and acquisitions, and it does not take much imagination to envision the potential for abuse here should a larger BHC acquire a small insurance operation and then rapidly expand its operations. PIA believes that the real solution to the concentration problem is to prevent BHCs and insurers from engaging in each other's businesses as a matter of law.

Subsection 104(h) of S.2181 and Section 14 of S.2134 attempt, although ineffectively, to deal with the so-called "South Dakota" situation. Subsection 104(h) provides that a state cannot authorize banks which it charters to engage in insurance outside of that state on a different basis than that authorized for such banks within the state. This speaks only to the exact provisions of the South Dakota banks-in-insurance law and would be easily skirted by utilizing an approach that would allow a state to authorize nationwide insurance services that included the authority to also conduct this same business within the authorizing state. In reality, this provision provides no real substantive relief to the insurance industry.

Section 14 of S.2134 provides that state-chartered institutions cannot commence any activities such as insurance unless the activity is authorized by state law prior to January 1, 1983, permitted under Section 4(c)8 of the BHC Act, or authorized by state statute and performed exclusively in that state for its residents. This approach still has the inherent weakness of states potentially allowing expanded BHC insurance activities on an intra-state basis. In certain large and economically significant states such as New York, Illinois, Texas, California, and possibly others, this would present a special problem to insurance interests operating within their borders.

Both Subsection 104(h) and Section 14 would undercut the general BHC insurance probhitions contained in Title VI of the Garn-St Germain Act, as well as the federal government's authority to properly and thoroughly regulate the national activities of BHCs. It destroys the concept of a national banking policy.

Subsection 104(h) also amends the BHC Act to provide that states may not prohibit affiliations between BHCs and companies engaged in activities authorized by Subsection 104(d), (e), and (f) of S.2181. This provision is unacceptable because it would curb the current authority of states to generally enact intra-state prohibitions on BHC activities that are more restrictive than federal law.

Section 105 of S.2181 and Section 18 of S.2134 would add a new Section 23B to the Federal Reserve Act. In addition to dealing with transactions between banks and affiliates, Section 23B would allow a bank and its holding company affiliates to use a similar or common corporate name or logo for all of the holding company's operations. It would also prohibit a bank and its affiliate from advertising and entering into agreements suggesting that the bank is responsible in any manner for its affiliate's obligations. This is all well and good but, realistically, it does not speak to the competitive issue which hinges on public perceptions. Such a provision does nothing to deal with the reality that by using common corporate names or symbols, the average citizen still will come away with the perception that holding company activities are part of this banking organization and, as such, are protected by the United States Government. This, again, as a practical matter, provides BHC subsidiaries with a powerful competitive advantage, the proposed substantive reality notwithstanding.

Under current law, Section 106 of the BHC Act Amendments of 1970 contains a broad prohibition of tieing products and services.

Section 107 of S.2181 attempts to create additional consumer protections for credit insurance sales by a bank. Banks: would be required to notify borrowers that insurance may be purchased from the seller of their choice, be forbidden from soliciting insurance until the credit commitment has been made in writing, could not reject property insurance provided by others on an unreasonable basis, cannot disclose renewal information without the borrower's written consent, and provides a 30-day right of cancellation for insurance sold by the bank. Trade associations are also authorized to seek injunctive relief on behalf of their membership to enforce anti-tieing provisions.

The aforementioned anti-tieing provisions are obviously an attempt to placate the concerns of the insurance industry. PIA believes that this can also be interpreted as a clear admission that there are indeed valid issues being raised by our industry concerning credit/insurance tie-ins and related abuses. Unfortunately, all anti-tieing provisions suffer a common flaw in the real world -- they don't work, nor do they even inhibit the abuses they are intended to prevent. PIA has dealt with this issue,in terms of coercion of debtors statutes,at the state level for years. A number of states have very stringent anti-tieing provisions which also suffer from the problem that they don't work either. As a practical matter, tie-ins are extremely difficult to plead and prove in court because the events are always couched in terms of, "Well, so and so said," or "I got the impression that," and "I was led to believe that it would be best if." It is the word of one party against that of the other. It is also next to impossible to get plaintiffs to pursue their legal rights because they fear, no doubt with some justification, that such actions would jeopardize their line of credit with their banker.

The trade association injunctive remedy, besides suffering from these aforementioned enforcement difficulties, also would commit insurance trade associations to endless and costly ongoing litigation expenses in each of the 50 states. In summation, a remedy that is ineffective is not a remedy at all. The only anti-tieing provisions that will really work are legal provisions, such as Title VI of the Garn-St Germain Act, that prevent depository institutions from engaging in the general business of insurance.

Under current law, unitary S&LHCs are under no restrictions regarding non-S&L activities, such as insurance, if their S&L qualifies as a domestic building and loan association under the Internal Revenue Code.

Subsection 108(b) of S.2181 provides that unitary S&LHCs, whose S&L qualifies as a "qualified thrift lender" (QTL), thereunder would be subject to no restrictions on the insurance activites of its non-S&L subsidiary.

Unitary S&LHCs not qualifying as a unitary QTL would be subject to the same activities restrictions as multiple S&LHCS, which includes the right to function as general insurance agents. They would also receive all new powers authorized under Subsection 104(d) for BHCs. Under this provision, these S&LHCs would be able to function freely in insurance sales and as underwriters. Again, such an expansion of authority is totally unacceptable to PIA.

Subsection 108(b) imposes the same test on cross-acquisitions between S&LHCs and other financial services providers as Subsection 104(d) imposes on such acquisitions by BHCs. We refer the Committee back to pages 13 and 14, regarding our analysis of Subsection 104(d) because PIA's position there is equally applicable here.

Subsection 108(e) would prevent states from prohibiting federally-chartered thrift holding companies from engaging in the expanded S&LHC activities authorized under S.2181. The abrogation of a state's right to control thrifts under its jurisdiction is opposed by PIA.

Subsection 109(b) of S.2181 amends the Home Owners' Loan Act to authorize trade associations to seek injunctive relief against S&L organizations in violation of anti-tieing prohibitions. This is like Section 107 and we refer the Committee to our discussions of these issues on pages 16, 17 and 18.

Lastly, both bills are, at best, unclear, but in most instances ignore the state regulation of insurance. In some sections, particularly in the examination procedures, conflicts arise. The anti-tieing provisions are, in fact, less stringent than those in several states, Iowa being one. Ultimately, from an insurance regulatory perspective, one that is overseen at the state level, these bills are unworkable. As a longtime and committed advocate of state regulation of insurance, we find this situation unacceptable.

# # #

STATEMENT OF RICHARD A. NIELSEN, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE BROKERS; PRESIDENT, JOHNSON & HIGGINS OF DELAWARE, WILMINGTON, DEL.

NAIB NATIONAL ASSOCIATION OF INSURANCE BROKERS
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March 6, 1984

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
U.S. Senate
Washington, D.C. 20510

Re: Statement for the Record
March 6, 1984 Hearing
on S. 2181 and S. 2134

Dear Mr. Chairman:

The NAIB represents major commercial insurance brokers with offices throughout the United States and around the world. Our members sell and service the majority of the nation's business-related insurance coverages. It is the primary function and responsibility of a commercial insurance broker to develop insurance programs and provide related products and services to protect the assets of clients.

Historically, the National Association of Insurance Brokers (NAIB) has remained neutral in the debate on financial services deregulation, including the question of whether banks should have expanded insurance distribution and underwriting authority. This position was built on NAIB's support for open competition in the delivery of insurance products and services.

In this context, NAIB member firms continue to believe that competitive innovations, including new methods of distributing financial insurance products and services, benefit clients. Our member firms are part of a highly competitive industry that welcomes fair competition. NAIB recognizes, however, that lending institutions enjoy decided and potentially unfair advantages, a) because individual and corporate consumers will link the purchase of financial products, including insurance, to the extension of credit, and b) because banking institutions have access to federal deposit insurance and federal funds to support their operations.

It is also important to note that insurance is unique among financial products distributed by lending institutions in that insurance requirements typically are an inherent part of the loan transaction. Evidence of insurance often must be established before credit commitments are fulfilled.

Therefore, on March 3, 1983, the NAIB board of directors voted to express its support for Title VI of the Depository Institutions Act of 1982 (P.L. 97-320), which restricts the distribution and underwriting of insurance by bank holding companies.

Thus, it followed that in testimony before your committee on June 7, 1983, NAIB joined its fellow insurance producer trade associations in opposition to the Administration-proposed Financial Institutions Deregulation Act (S. 1609). NAIB also opposes the Financial Services Competitive Equity Act (S. 2181) and the Depository Institutions Holding Company Act Amendments of 1983 (S. 2134).

While it is true that S. 2181 attempts to deal with credit tie-in abuses by lending institutions, NAIB does not believe anti-tying mechanisms can be designed which will effectively protect the insurance buyer.

Even when financial institutions take no action that would tie credit to the purchase of insurance products and services, lenders have an intangible leverage that is inherent in any credit transaction. There is ample evidence that individual consumers, when confronted with a question about purchase of insurance at the time they are receiving credit, assume that purchase of the insurance is part of the lending package.

The lenders' intangible leverage could be present in transactions with more sophisticated buyers, especially commercial customers, even though lenders don't attempt to coerce their customers. The fact that a tie-in is illegal is irrelevant in the business context, because savvy businesses are likely to assume that their relationship with a lending institution will be strengthened if they purchase insurance products and services along with credit. Furthermore, it is virtually impossible to legislate against this intangible leverage, this tie-in, from happening in practice.

The proposed remedy for tie-in abuses -- allowing a right of action for trade associations whose members claim to have been harmed and injunction relief -- does not solve the problem. Evidence proving that anticompetitive tying has occurred generally is just as intangible as the leverage lenders would have if their insurance authority were to be extended. In addition, the time and costs associated with law suits make this option less than useful.

S. 2134 presents a problem not unlike the one posed by South Dakota last year when legislation was adopted that grants insurance authority to state chartered institutions. The question then arose as to whether a federally chartered bank holding company acquires the state-granted insurance authority when it acquires a state chartered institution. In it's approach to the issue, S. 2134 perpetuates the question of whether a state can confer new authority on federally chartered institutions. Section 5 of the bill would continue the ban bank entry into insurance currently in force under the Bank Holding Company Act. On the other hand, section 14 of the bill provides that bank holding companies may engage in any activity specifically authorized by a state and performed exclusively in the authorizing state.

NAIB supports the nation's dual banking system which recognizes the authority of states to govern the activities of state chartered financial institutions. It does not logically or sensibly follow, however, that states should have the authority to impart powers to federally chartered bank holding companies beyond those provided for under federal law. Thus, NAIB is opposed to the concept embodied in section 14 of S. 2134.

In addition to endorsing Title VI of the Garn-St. Germain Act, NAIB's board also affirmed the association's support of state regulation of insurance. NAIB is opposed to financial services deregulation proposals that could lead to federal regulation of the insurance industry and changes in state laws that would enable lending institutions to circumvent the intent of federal law. We see, for example, that the banking community is pushing vigorously to enact new state laws to circumvent the Congressional intent of Title VI restricting the distribution and underwriting of insurance by bank holding companies.

As we have noted, one of the most significant problems posed by the entry of lending institutions into the insurance brokerage business is the unfair competitive advantage due to the potential tie in between extension of credit and purchase of insurance products and services which cannot be legislated out of existence. This unfair competitive advantage is compounded by the fact that lending institutions have access to privileged financial information of their customers.

As the principal representative of the client in the insurance marketplace, brokers are concerned that insurance consumers not be placed at a competitive disadvantage by being coerced through intangible leverage into buying insurance services from one source, such as a lending institution. This is particularly true in situations where lending institutions may have side-stepped existing regulatory requirements, accumulated weak or improperly secured loan portfolios, or placed their depositors and their clients at undue risk through mismanagement.

Whether it is intangible leverage or direct tie-in that leads consumers to a lending institution for insurance products and services, it is the consumer who will be poorly served if banks are allowed to ignore federal law and enter the insurance business. We believe the existence of a competitive financial services marketplace for insurance where consumers can make free choices has served our nation well. The system which separates banking from the insurance industry continues to work for the benefit of insurance buyers.

We appreciate your consideration of NAIB's views and would be happy to provide additional information at your request.

Sincerely,

William A Quinn

William A. Quinn
President

William S Jennings

William S. Jennings
Chairman
Laws and Legislation Committee

The CHAIRMAN. Thank you, Mr. Woods.

Before we start on any questions, do any of the others of you on the panel wish to make any comments?

[No response.]

The CHAIRMAN. First, let me make some observations, Mr. Woods, about your testimony. As we've dealt with this problem, particularly the insurance aspect of it, I do believe I know something about it. If you're not aware, Ken and others are, that before I got into politics I made my living as a life underwriter, so I do think I know something about the industry and I am also quite well aware of tie-in sales. I lost some sales to tie-ins.

So if I had any bias, it would be toward your point of view from having made my living for more than a decade in the same way you make yours.

TIE-IN SECTION OF S. 2181

So I agree with much of what you say and I think most people are well aware that the section of the bill in Garn-St Germain stayed in because I kept it in, and yet the constant questions come back of what have you done for me lately, not what did you do last year. And why is it in this bill again?

Well, I'll tell you why. So that everybody understands why it is in the bill, it is a subject that is controversial and will continue to be so. We could have left this section out of the bill again and say that was decided last year, but that wouldn't decide it. And then what you would face is at some point in the process, in the markup, or when it gets to the floor, or late night session, somebody pops up with it.

I just happen to think that in this whole process, not just the sections of the bill that you're interested in, that the more controversial issues deserve to be up on top of this table and this one so that you have your opportunity to express your viewpoint.

So I've been asked that question over and over again by insurance people—why is it being addressed again? It is being addressed again because it is a controversial issue and I happen to think it's better to put it up on top of the table or you wouldn't be here today. You would be out behind the scenes trying to decide if somebody is going to come up with an amendment, is anybody going to try and bring this up?

I think this is the proper way to handle it. So that's the answer of why it is here.

But beyond your specific concerns about the insurance section, which I fully understand, I'm a little bit puzzled by your testimony—and not just this coalition alone but many others through these hearings—of the sort of assertion that this is just really banks asking for more power.

As I read through your testimony as you were reading it, there's absolutely no reference to Merrill Lynch, to Sears, to Prudential—one reference to Prudential/Bache—and so on.

What I'm trying to look at is the total picture, and I think it is unfair to single out one segment of the financial services industry and indicate that this whole process is driven by them.

Now, Ken, in Salt Lake City, in response to a question, I said, "Well, if it's fair for banks not to be in the insurance business, then how about insurance not being in the banking business?" And Ken, the insurance witnesses there, said, "We agree with that."

So all I'm saying is I do think you have to look at the total process. You have to go back and look at money market funds. I'm sure that former Chairman Proxmire, a distinguished colleague from Wisconsin, would agree with me. During a large number of years there was no great demand, there was no flow of people coming in here saying we want this and we want that until the marketplace started to change, and primarily by nonbanking entities getting into the banking business.

And I think it's important and I think in your testimony you ought to recognize the broader picture. Again, I'm not talking about your concerns about tie-ins with the banking business being in insurance, but your comments about how they are coming in and demanding this and that and so on, because I think you do have to look at that total picture.

Prudential is buying Bache. You've got to look at Sears. Sears has some power too. They have been in the insurance business for a long, long time. I found them a pretty tough competitor even years ago when I was involved when you could buy your lawnmower and your insurance and they were right together in the Salt Lake City store down in the lower level. Allstate was right there with the lawnmowers. And so I would like you to focus on the broader picture of what is driving this and it isn't any one segment of the industry.

There are a lot of people who have been trying to get into somebody else's business and that simply, in my opinion, cannot be ignored and you have to try and balance that out.

The other thing that I'm wondering about is your comment that talks about the fact that the problem of bank failures is directly relevant to the question of deregulation and expanded powers.

Can you give me any examples of bank failures as a result of deregulation?

Mr. WOODS. Perhaps our attorney, Mr. Wilson, will address that question.

Mr. WILSON. Well, the point of the statement, Mr. Chairman, was that the banking industry already has a great many problems and in fact the FDIC recently reported in connection with the Butcher banking situation that it had to put fully one-quarter of its manpower just to sort that out.

If you have that kind of strain on the regulatory system on something like the banking system that exists in such a tender psychological climate which I think everybody recognized, and you superimpose upon that disparate regulatory structures because insurance is regulated at the State level and so on, these new activities which bank regulators are not very knowledgeable about and so forth, it's going to put an immense strain on a system that is already well-taxed.

THE PROBLEMS OF BANK FAILURES

The CHAIRMAN. Well, I understand that, but that's quite different than your statement. There is an implication here that many of these failures have occurred as a result of deregulation.

Now the Butcher bank situation, Penn Square, had absolutely nothing to do with deregulation. As a matter of fact, the major deregulation bill didn't become effective until October 1982 and the problems of most of your banks were due to several things—general condition of the economy that had nothing to do with deregulation, high interest rates. In the case of Butcher, you're talking about fraud, dishonesty. In Penn Square, you're talking about some possible fraud in that case as well, very poor management, energy loans far beyond what should have been made with the rapid growth of a bank, and I just don't think that it's correct to indicate, even if that was not your intent, whether you like deregulation or not, you have arguments of why you don't want banks in the insurance industry, which I say I have a great deal of sympathy for, but to expand this to the whole process of deregulation and setting national policy that banks are out there failing because of deregulation that has taken place, just from a time standpoint—I don't want to let that implication hang.

I think you should be more careful in being specific in your testimony when you go beyond your area of expertise because that simply isn't the case. You can document why these banks have failed, why most of them are in trouble, and it has nothing whatsoever to do with expanded products or services or anything else, nothing, absolutely nothing. Maybe it does in the future, but that's another question. In response to your statement that if and when we reach a national policy decision on powers and authorities, then the next step is the regulation.

I would agree with you, present regulation is not adequate to handle that, and that's why we need to look at regulation by function, and if somebody is going to be in the securities business, then everybody that's in the securities business ought to be regulated the same. If Merrill Lynch wants to be a banker, then they ought to be regulated the same way for those same services.

So you are correct that those are steps that are going to have to take place and we can't try and do something about the regulatory functions until such time as we decide who is going to do what.

But again, this whole line of thought that I'm going into to begin with is to indicate that there are a lot of different actors in this whole process and just one segment—I'm not here to say the bankers are all clean and they wouldn't like to get into somebody else's business—they would, but there's a lot of other actors, including insurance companies, who want to be banks and savings and loan executives and so on, and that's what we were trying to drive at in Salt Lake. And Ken and my Salt Lake witnesses were the first ones that have been totally candid about it, to flat out say it's wrong for these banks to be in our business, but it's wrong for the insurance companies to be in the banking business.

You really can't have it both ways, in my opinion. You just really can't. You've got to take both sides of the coin and not just one.

Mr. WOODS. Mr. Chairman, we couldn't agree with that statement more. We don't want it one way.

I would like to point out that my statement does not imply that deregulation has caused bank failures. Rather, I was simply expressing my concern about superimposing riskier authority with less stringent oversight on a regulatory system that even the Federal Deposit Insurance Corporation said was not as effective as it might have been in helping them cope with the Butcher banking collapse.

What we're saying is to superimpose on that an even more complex system certainly is dangerous.

The CHAIRMAN. But your statement was in particular circumstances bank failures vary, which is certainly true, and we contend that they are directly relevant to the question of deregulation and expanded powers. I wanted to make it very clear that I know of no example—and I'm sure that no one can find one—where a bank has failed for that reason.

I also think it's important to note that, yes, there have been some great difficulties in the banking industry, but the vast majority of our banks, savings and loans, credit unions in this country are small. They are not the big boys; 14,000 banks, 4,000 or 5,000 savings and loans, several thousand credit unions, and so on. Most of them are extremely well-managed, are not in risky ventures, and were not in trouble even with the very great difficulties.

So I think we should not generalize there either. It's just like with the insurance business. The vast majority of agents that I knew were good, honest people who are serving their clients well and advising them properly, and you and I know that there are some in your local association, like there were in mine, we'd like to get out because of the way they misrepresented and twisted our policies and all sorts of things, and I think with any of the different industries we should not generalize and try and create implications because we can do that with any one of the industries.

NATIONAL POLICY NEEDS TO BE SET BY CONGRESS

I'm trying to face rapid changes in the marketplace and trying to set some national policy so that we do not have more aberrations like South Dakota, because the marketplace will not wait and neither will the States, and neither will the regulators until Congress—and we are in agreement on that—that whatever the decisions are, they ought to be made here in Congress, and that's what I continue to try to emphasize to all of the witnesses. Despite the fact there are individual differences of opinion on legislation, that's why it's before us, to gather all of those differences of opinion. I think we should agree that there are decisions that should be made here by Congress and not left to the hodge-podge of States to make their individual decisions, and yet I will defend their right to do so until such time as we come to grips with them and I also feel very strongly that the regulators often exceed their authority and have not been given the legislative authority to make some of the decisions they do.

So whatever differences of opinion are, I hope that we are able to take some action this year, whatever that action is. My time is up. I'll be back with some more questions. Senator Proxmire.

Senator **PROXMIRE**. Thank you, Mr. Chairman.

Gentlemen, I have questions for you. I want to get to them right away. But before I do, I do want to tell you what my bias is. I happen to think that we have a superlative system now. I think it's the best we've ever had historically and I think better than any other country. We have the unique diversity of financial institutions, unique because other countries have three, or four, or five big banks that dominate their whole financial situation. That's true in England, Canada, Germany, Japan—you name the country, outside the United States, and they just don't have the 30,000 separate financial institutions we have.

I think that's healthy. It's competitive. It means that local communities have their own institutions, and I think that's great. I think that's what I'd like to keep.

I think that we're in trouble, however, and I think timing is very important. Chairman Garn is pushing these hearings and I think he's absolutely right to do it and I strongly support him in trying to get action as he just said so well by the Congress rather than have the aggressive conglomerates move in and take over.

I am very concerned about the safety and soundness of banks, even though to date I think the chairman is correct that we haven't had to worry about banks failing because of expanded powers. But I think in the future, as he indicated, we might. There's certainly a conflict of interest, as you pointed out so well, Mr. Woods, in your statement, when you have a bank having a lot of capital moving into some of these areas. They have enormous advantage over their competitors. It's an unfair advantage.

You also have, of course, a real possibility of financial concentration and that concerns me. Concentration would contradict what I talked about, the diversity of capital that we have had and which has served our country so well.

Now with that in mind, let me ask you first, Mr. Woods, and if any of you other gentlemen would like to join in, fine, you have opposed the South Dakota loophole provision in my bill because it does not go far enough.

Now my bill prohibits Citicorp from getting into the insurance business ouside South Dakota, but you also want to bar bank holding companies located in South Dakota from getting into insurance.

CURRENT LAW VERSUS THE SOUTH DAKOTA PROVISION

Let me just ask you. Would you prefer current law to the South Dakota provision I have?

Mr. **Woods**. I think what we would prefer, Senator Proxmire, is that the current Bank Holding Company Act be properly implemented.

And the second part of what we would prefer is legislation to reaffirm that a bank holding company could not derive greater power from a State-chartered subsidiary than is provided to them under Federal law.

Senator **Proxmire**. Well, I understand what you would prefer but that wasn't my question. My question was: If you had a choice between present law and the prohibition for banks like Citicorp getting into the insurance business outside of South Dakota, which would you take?

Mr. **Woods**. Maybe my fellow panelists would care to respond.

Mr. **Nielsen**. Senator, there seems to be some agreement that the current law would be fine but that the Federal Reserve may be interpreting that law other than the way it was intended by Congress.

Senator **Proxmire**. So you're concerned with the interpretation of the law and I take it that you feel that the provision I have prohibiting Citicorp from getting into the insurance business would not clarify that interpretation adequately?

Mr. **Nielsen**. Well, I think it's fine on the first point. We're all for State regulators doing what they want in their State. The problem, as Mr. Woods stated it, is allowing States to grant powers to a subsidiary of a bank holding company beyond Federal powers.

Senator **Proxmire**. Well, then, would you prefer no legislation to what I have? We're not going to be able to serve any group completely. The chairman, I think, can speak with more authority on that than I can, but I'm sure we can't design legislation that's going to satisfy any group very completely. You're going to have to accept some kind of compromise and what I'm trying to find out is what you would accept.

Mr. **Osborne**. Senator, we certainly supported title VI and we thought that would answer the problem. Now the attorneys of the big banks have found ways to make an end run around that and we would support legislation that does what we thought title VI was going to do. We think the present legislation is adequate and we support the present legislation.

Senator PROXMIRE. All right. Now let me ask you about another problem I have and I hope that when I ask this, because it relates to my State that you don't assume that I favor what my State has done because I often do not. But a State-chartered bank not part of a bank holding company in Wisconsin can now, because of a change in the law in the last few months, can engage in insurance.

Do you think the Federal Government should preempt the Wisconsin law?

Mr. WOODS. Senator Proxmire, we would agree with the chairman's statement before. It seems to us the States should have the right to do with a State-chartered bank whatever the State decides it wants to do with a State-chartered bank. So we do not think that in that particular application that the Federal law should preempt State law.

Senator PROXMIRE. You think in that case what?

Mr. WOODS. We do not think that the Federal laws should supersede State laws when dealing with a State-chartered bank as long as that State-chartered bank is not a subsidiary of a federally chartered bank holding company. Is that responsive to your question?

Senator PROXMIRE. Well, let me ask you then, if that same State-chartered bank converted itself into a bank holding company, you want to prohibit the bank through Federal law from using its insurance powers?

Mr. WOODS. Yes, that's right.

Senator PROXMIRE. What's the difference? If we permit one, why not both?

Mr. WOODS. The difference, it seems to me, is that we're talking in the first case about strictly a State matter and we don't believe that Federal law should supersede State law when dealing with State matters. But once that State-chartered bank converts itself into a bank holding company it comes under Federal law and obviously Federal law should then apply.

Senator PROXMIRE. Well, what are the public policy reasons for prohibiting the bank in one case from proceeding and in the other case from letting it go right ahead?

Mr. WOODS. Well, it seems to me that you're creating a fairly chaotic situation, aren't you?

Senator PROXMIRE. Well, you have to begin with the fact that under our dual banking system a State decides whether State-chartered banks can get into the insurance business.

Mr. WOODS. Yes.

Senator PROXMIRE. One State might allow insurance and not another. Such action might contradict Federal policy, but we shouldn't preempt the right of a State to do so.

Mr. WOODS. Yes, sir. That's the State's prerogative and we would support the State's right to do that.

Senator PROXMIRE. Let me find out if I understand your response to the chairman. Do you support legislation that would require insurance companies to divest themselves of nonbank banks?

Mr. WOODS. We would support that, yes.

COMMERCIAL BANKS ARE PRESSING FOR FURTHER DEREGULATION

Senator PROXMIRE. Fine. I agree with that. Now commercial bankers in pressing for further deregulation of the industry argue that banks are being forced by the existing regulatory system to operate at a serious competitive disadvantage. While other types of institutions are being allowed to offer services highly competitive with many banks functions, bankers complain free entry is working only in one direction. They suggest that too often legal and regulatory constraints prevent them from effectively competing through entry in the market where other types of institutions are the traditional financial service suppliers. Those restraints, it's argued, reflect an outmoded regulatory theory that has no relevance in today's world of rapidly changing and increasingly competitive financial markets.

What's your response to that?

Mr. WOODS. I think what our response to that is that we're asking Congress to make the determination and decide on the separation of these institutions. I think, if I understand what you're saying, Senator, we are concerned not so much about the merging of Sears Roebuck and Dean Witter because we're not talking about a banking institution there. It's the credit leverage. It's the credit privileges that a bank has that makes all the difference. And so while the banks may lament that they can't become a Sears-Dean Witter kind of combination, we think it's inappropriate for them to become a Sears-Dean Witter banking situation because the addition of banking changes the whole nature of the combination.

Senator PROXMIRE. Because they have what you call credit leverage which gives them a peculiar special advantage?

Mr. WOODS. Absolutely right.

Senator PROXMIRE. I think that's a good point.

The CHAIRMAN. I would just interject one thing. When you say you're not worried about Sears, doesn't Sears own one of the largest savings and loans in the country?

Mr. WOODS. I believe they do.

The CHAIRMAN. Yes, they do.

Mr. WOODS. Well, we would not support that.

The CHAIRMAN. That was my comment about looking at the whole picture. There are some of the new actors.

Mr. WOODS. But, Mr. Chairman, I say again that we would oppose that. We do oppose that because we think that's inappropriate. They've got the Allstate Life Insurance and to combine that with the credit leverage of the savings and loan, we would be opposed to it.

Mr. NIELSEN. Senator, could I add something to that, talking about Sears? I think what Dave was saying really is that, putting aside their savings and loan association, we are not afraid of competition from Sears. Putting it another way, we're not afraid of IBM, or Exxon, or General Motors getting into the insurance business. We are not afraid of competition. It's unfair competition through credit leverage that's the one difference between banks and other lending institutions and other potential competitors.

Senator PROXMIRE. Now let me ask you this, Mr. Woods. There are two predominant assumptions underlying the arguments in favor of further banking deregulation. No. 1, the commingling of all types of financial services they say is inevitable and appropriate; and second, the consumer will be well-served by large financial conglomerates. What's your reaction?

Mr. **Woods**. Perhaps my colleagues would like to speak to that.

Mr. **Osborne**. Senator, we would disagree with both of those. As our position is stated in the past, we really feel the responsibility is for Congress to decide and not the marketplace. We feel that you have the expertise to do that and should do it and not have the marketplace and their legal staffs decide what we do in financial regulation and deregulation.

Mr. **Custis**. Senator, we also feel that that could result in a limitation on consumer choice regarding services and products, if that was to occur.

Senator **Proxmire**. Do you have a comment, Mr. Nielsen?

Mr. **Nielsen**. Yes. We hear a lot of talk about the marketplace driving deregulation and that, therefore, Congress and everybody else has to catch up with the marketplace.

I would submit, Senator, that's a little bit like saying that if enough companies get together and fix prices, we should change the antitrust laws in their favor.

Clearly, some of the sellers and providers are forcing the issue, no question about it in the various States. But I think there are some national policies, as the chairman and you have stated, that go beyond what various vendors are trying to force here.

Senator **Proxmire**. Do you believe that a bank insurance tie-in sale can ever be effectively legislated against?

Mr. **Osborne**. No. It really couldn't be. The legislation suggested to wait 30 days. When that either implied or applied credit tie-in is there, that person is going to let the bank write the insurance.

PRECLUDE BANKS FROM SELLING INSURANCE

Mr. **Custis**. Senator, also the record perhaps speaks for itself in that regard as well, but we are opposed to anything that has the potential for the tie-in sale and have tried hard to see if there was anything that would be acceptable and have not been able to come up with anything at all that would be acceptable, other than precluding banks from selling insurance.

Senator **Proxmire**. So if a person wanting a mortgage on his home goes to the bank for the mortgage and he needs that mortgage in the worst way and he knows the bank sells insurance then the bank knows he's going to have to get insurance. It's going to be pretty hard for him to resist the bank, whatever the terms are on the insurance. Certainly on the credit life, he doesn't have any shot at it at all, right?

Mr. **Custis**. If that's the case, then I would submit that that's wrong and should be changed.

Senator **Proxmire**. Finally, savings and loan associations in a number of States have been permitted to run insurance agencies through their service corporations for a number of years. If savings and loan associations may engage in this activity, why shouldn't commercial banks be allowed the same opportunity?

Mr. OSBORNE. Some of those banks are under the present grandfather clause under the Garn-St Germain bill. The size of the city, whether they've been in business—for instance, in our community First Security Bank is grandfathered. They've been in the insurance business for a long time and this would not——

Senator PROXMIRE. I'm not talking about grandfathering. I understand savings and loan associations just have the right to do it.

Mr. OSBORNE. Savings and loans are in it and the banks are grandfathered also.

Senator PROXMIRE. Well, if the savings and loan associations are in it, why shouldn't the commercial banks be allowed to go into it, whether they're grandfathered or not? Why not?

Mr. OSBORNE. The same thing as we have stated before of credit tie-in and the unfair competition that they would have.

Senator PROXMIRE. Why wouldn't there be a tie-in for the S&L?

Mr. OSBORNE. There is.

Senator PROXMIRE. Why don't you object to it then?

Mr. OSBORNE. We object to that. We object to the savings and loans. We object to the life insurance companies. You know, this gets a little heavy, but I guess what it really comes right down to is, we're really pleading and asking for a right to continue to do business as we've done in the past. We don't feel that the public has been ill-served by the insurance industry and we do feel that it would be ill-served if the banks, especially the large banks, were able to come in with their power and credit tie-in and take that insurance sale away from the independent agents.

Senator PROXMIRE. Thank you.

Mr. WOODS. Senator, could I just tag on to that answer for a moment? I personally believe that it is possible to legislate in such a way as to prevent tie-in sales and that's simply by legislating the separation of banking and insurance so that the possibility does not exist. Frankly, we feel the same way about the savings and loans. We don't think that you should allow the commercials to do that which the savings and loans are doing. We think that what the savings and loans are doing is unfortunate and we would be opposed to that kind of opportunity for tie-in sales wherever it exists.

Senator PROXMIRE. My time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Nielsen, you say that you're not unwilling to compete as long as it's fair. Sears recently renamed—one of you said you weren't afraid of Sears—it renamed Allstate Savings and Loan Sears Savings Bank, and what about credit tie-ins? What about G.E. Credit selling insurance? G.E. Credit is a very large institution, not a bank, and they sell insurance.

Mr. NIELSEN. I'm not familiar with G.E. Credit except is it mainly commercial lending as opposed to consumer or retail lending?

The CHAIRMAN. That's correct.

Mr. NIELSEN. As far as Sears is concerned, I think we've answered that question in terms of any lending institution.

The CHAIRMAN. All I'm trying to drive at is it seems to me that if you're consistent and you fear unfair competition, that again you've got to broaden it. There are a lot of people who have credit tie-ins who are not banks, who are not savings and loans. It seems to me that to be consistent your statement should be you oppose all of those.

Mr. **Nielsen**. I'm not sure I agree with you, Senator, with all respect. I think the savings and loans——

The **Chairman**. You don't have to have respect. [Laughter.]

Mr. **Nielsen**. Well, I do anyway. I think we could probably all agree that the savings and loans and banking industry are different from the G.E. Credit Co. or the General Motors Acceptance Corp. or the other so-called credit givers in a lot of respects that I won't go into, because I'm sure you know them better than I do.

I think what we're really saying is that the normal savings and loans and commercial banks, as we've understood them, have an inherent advantage in their granting of both commercial credit to business, large and small businesses, and on the retail level to individuals. I think it's just that simple.

Mr. **Woods**. The banks as depository institutions do have unique privileges when it comes to the nature of the institution and it gives them powers in terms of granting credit which are really very different from that of G.E. Credit or whatever it is. They are powerful institutions. They are under different kinds of regulations. I keep using the word "power," because that's what it is, it's greater than G.E. Credit or whatever you're talking about. It's a different kind of an animal I think.

The **Chairman**. Well, you're aware that if any new powers were granted banks, there is no legislation I'm aware of that doesn't insist that it be in a separate subsidiary.

Mr. **Nielsen**. Senator, one difference is that G.E. Credit doesn't have FDIC insurance. They don't have the ability to go to the Federal Reserve as a lender of last resort. I think that's one thing.

The **Chairman**. No, but they may figure out how to be brokers and deposits too, like the securities people. Who knows?

Mr. **Nielsen**. But that is one difference. The Federal Government is much more involved both in insurance and as a lender of last resort in the savings and loan and banking industry.

WOULD THE SEPARATE SUBSIDIARY SOLVE THE PROBLEM

Mr. **Woods**. Well, would the separate subsidiary really solve the problem? You're still talking about the same corporate structure. I don't know whether we can really alleviate the problem that way.

The **Chairman**. Well, I personally don't think so.

Mr. **Woods**. OK. We agree.

The **Chairman**. I have never felt the separate subsidiary was necessary. That was not my choice. I just learned to count around here and that was the necessary ingredient in Garn-St Germain, if those had gone through or in this, that Treasury and the securities industry and lots of other people insist that it be set up in a separate subsidiary and remove it from the deposits and make it an entirely different animal. So you and I are in the minority on that issue.

But in any event, to those who believe that, I just make sure you're aware that many people who would make that argument of setting it up in a separate subsidiary divorces it and takes the risk away from the parent organization, whether it's real estate, insurance, or anything else. I think the REIT's proved that that was not the case and did not provide the insulation. Now I am speaking of personal opinion, that a fact of life is that if these powers are granted they will be in a separate subsidiary. That decision has been made.

Mr. Woods, you're from Massachusetts. What is your view of the situation of the consumer benefits that the Savings Bank Life Insurance has in Massachusetts? I understand that's been going on for more than 60 years in Massachusetts.

Mr. WOODS. The Savings Bank Life Insurance in Massachusetts, Connecticut, and New York, which are the three States which have it, was created for a very specific reason by Justice Brandeis and that was to provide an alternative to what was then perceived to be and probably was relatively high-cost industrial insurance. Savings Bank Life Insurance was sold for many, many years in very small amounts to the consumers who were the traditional purchasers of the old industrial $500 policies and so forth. It's grown somewhat in the meantime. Frankly, in all three States, the Life Underwriters Association and other organizations have opposed the growth of Savings Bank Life Insurance for the very reasons that we've expressed to you here this morning—the credit tie-ins and so forth.

So while it has grown in Massachusetts, it has not been without a battle and we continue the battle for the reasons we have expressed here this morning. We are not opposed by the way to the traditional role of Savings Bank Life Insurance. Justice Brandeis started the thing and it made some sense. It was a good alternative. What we're talking about, however, is so small that the credit tie-in didn't mean anything really, and as long as it would stay within those bounds frankly we would go along with it.

The CHAIRMAN. That isn't even credit related. It's my understanding that's whole life.

Mr. WOODS. Absolutely. It could be credit related, though, because the customer comes in for either a mortgage or a loan for whatever he wants and, of course, he walks right by the insurance.

The CHAIRMAN. Do you want to stop it in Massachusetts?

Mr. WOODS. I think we would like to stop it. I don't think it's practical to think that we can.

The CHAIRMAN. The Comptroller's Office recently in an interpretative opinion stating the national banks may lease space to insurance agencies based on the gross income of the agency or agencies involved. I understand that this raises some questions under some State laws but some banks and agents have already agreed to such arrangements. If any of you could respond, what is your view to those kind of arrangments?

Mr. CUSTIS. Mr. Chairman, I would comment on that by saying that I don't believe our organization has a policy as of yet. I think we would be opposed to anything that has the potential for abuse. Leasing space arrangements still provide many opportunities for abuse, tie-in abuses as well, and we would be opposed to anything that has that potential for abuse.

The CHAIRMAN. But these are voluntary agreements made by insurance agents who are just paying rent on whatever basis, gross receipts basis, for the privilege of being in the bank.

Mr. HILLMAN. Senator, I don't believe that eliminates the credit tie-in problem though. They may be independent insurance agents who are paying rent, but you still have the potential there for abuse from a credit tie-in because the rent is based on a percentage of the insurance agent's sales.

The CHAIRMAN. Well, I understand that, but whatever potential for abuse would still be there, but this is a voluntary arrangement with some of your colleagues within your associations who apparently hope the tie-in does work I guess. That's their theory.

Mr. OSBORNE. Mr. Chairman, the IIAA has taken the stand that we would leave this entirely up to the members, cautioning them that there would be the problem of the tie-in. They should look into their State antirebating laws and also it's tough enough in the insurance business to make it on 100 percent of commission. I don't see how an agent could go into a bank and pay 50 percent as they are asking. It just isn't feasible to give that much commission up. But I don't think we would take the position where we would tell our members not to do that, but we would caution them to make sure they were doing it legally.

CAUTION AGENTS ON TIE-INS

The CHAIRMAN. Wouldn't it be consistent with what you said here today that you ought to tell them not to do that? I agree that whatever the potential for tie-in there, it's the same, but it sounds like part of your membership is saying, "Hey, those tie-ins are all right."

Mr. OSBORNE. I really don't think one member of an association can tell another one not to do that.

The CHAIRMAN. You can't force him not to do it, but as a policy, are you treating your own members differently, hands off?

Mr. OSBORNE. No. I would think that in our meeting that's coming up in March that we probably will take a stronger stand on that and in fact it would be my opinion that we should take a stand and advise them not to do it.

Mr. CUSTIS. Mr. Chairman, I would also echo that our association hopefully will take a strong stand on that as well and try to discourage those types of things that have the potential for abuse. I would add that hopefully the members will have some clear direction concerning some of these changes that are going on in the financial services when it is appropriate to enact legislation to clarify these matters and hopefully those that may be looking into those arrangements because they're uncertain about the future will see no need to do so if the existing national bank policy is continued.

Mr. WOODS. Mr. Chairman, the National Association of Life Underwriters, like all the other organizations here today, believe deeply that in the long run what's good for the consumer is going to be good for our membership. In that context, although our association has not yet had a board meeting, I'm virtually certain that we will oppose those kind of arrangements for all the reasons that we have expressed here today. It is not in the interest of the consumer and ultimately if it isn't we are going to wind up paying a price for that. So we will undoubtedly oppose it.

The CHAIRMAN. As I'm sure you're all aware, just recently the New York State Financial Instititions Commission made some recommendations to the New York State Legislature and the Governor that for one thing permitted banks—the recommendations at least—to engage in broader insurance activities.

What are your opinions of State initiatives like that, any of you?

Mr. HILLMAN. Mr. Chairman, we would certainly feel that each State, as we stated, has its prerogatives but that does not preclude the fact that we would be opposed to them doing it. We believe that our individual State associations and their member insurance agents and lobbyists could lobby against such legislation and bring to the attention of the people in the legislatures in the various States the abuses and the credit tie-ins that exist, but we certainly are not in favor of the proposed New York type of legislation.

The CHAIRMAN. Well, are you specifically going to oppose it in New York State as associations then?

Mr. WOODS. Yes, sir. The New York State Association of Life Underwriters will oppose whatever legislation is drafted as a result of that and to the extent that we in the National Association of Life Underwriters are asked to do so we will certainly support the New York association's efforts there.

Mr. OSBORNE. Senator, the New York State IIAA, their State agents associations, is also against this legislation and is battling that now. So they are opposed to it.

The CHAIRMAN. Well, would you expect that if the Congress is not willing to make decisions on a national basis, would you expect that you will have more and more State initiatives around the country?

Mr. OSBORNE. Yes. I don't think there's any question about that and I think you're dedicated to that. You stated that before, that you feel there is the need for Congress to act and act now and you stated that in opposition to the moratorium and I suppose that's still your stand at the present time.

The reason that we feel that the Federal Government should at least make the outlines, the guidelines for the States to go along with, but the States should not be left to do their own things because 51 different laws would be difficult to handle and therefore the Federal Government should make the guidelines for the States to follow.

The CHAIRMAN. I understand what you're saying, but as a former insurance agent one of the laws that I liked best was McCarron-Ferguson. So you need to be careful when you get involved in national interfering with the States because you've got a situation now where you're regulated by 50 or 51 or whatever it is, but it's my opinion—at least it was when I was in the business—I much preferred dealing with the State insurance department rather than a Federal regulatory agency. So I would hope you would be careful in your advocacy because—I've said this to some of you before, certainly to you, Ken—the fear of insurance agents are back here arguing for too much uniformity in some ways and asking Congress to do this for us and do that for us. Some day somebody is going to come up and say, you're the last industry that's relatively free of uniform national laws and I certainly am not in favor of that happening. I'm going far beyond what you're talking about today. I think McCarron-Ferguson is correct and I do not want to see that broken up where then you're spending all of your time back here on the conduct of your daily business. I think you'd much rather deal with your local State organizations.

Mr. NIELSEN. Senator, we would support that 100 percent. I think on the subject of the States' initiatives, if Congress does not act, what we—and I suspect you—do not want are 50 States competing to see who can deregulate the most to attract jobs and industry and so forth. That's what we see happening. That, to some extent, is what's happened so far in a number of States, as you well know. That's the thing that we do not want is 50 States competing to see who can go farthest in deregulating.

The CHAIRMAN. Well, I would assume, though, that you would feel that depends on what they're doing within different State borders or whether they're trying to export their interpretations of the law to the other 49 States.

Mr. NIELSEN. That's correct.

Mr. WOODS. Yes; that's correct. But with regard to banking, we do see banking in a somewhat different light than we see insurance. Banking is a unique financial institution in our country and it seems to me that because of the unique nature of banking and the vital nature of banking in the commercial and economic life of this country that it must be regulated by you gentlemen here in Washington.

DUAL SYSTEM IN BANKING HAS SERVED WELL

The CHAIRMAN. Well, it will be. We are not talking in the same context. McCarron-Ferguson excluded insurance from that and you have a very strong dual banking system, both State regulation and State chartered and Federal regulation on the national banks. I happen to think that the dual system in banking has served us very well, as Senator Proxmire pointed out. We have a much more diverse banking system than other countries as a result of having preserved the dual banking system.

I would assume, gentlemen, that you would agree that we should try and avoid concentrations in a small number of organizations regardless of what type they are, not just banks but there are some very large insurance companies; there are some very large retailers, some very large securities firms in this country as well, and I would assume that we should be wary of concentrations of economic power in any of those, not just in banks, that we constantly hear about Citicorp, Bank of America, and Chase particularly, they're the three favorite boogie men, but there are other very large institutions in this country that we should also be concerned about concentrations of power.

Do each of you agree with that?

Mr. WOODS. I think I would agree in general that we ought to always be concerned about concentration of economic power.

While I personally, as a U.S. citizen, am opposed to concentration of economic power, speaking for my association, I can only say to you that we are opposed to the concentration brought about by the merging of banking and insurance.

Mr. NIELSEN. Senator, if I could add to that, I know of no industry that is more competitive than the insurance industry, either from the agency standpoint or from the underwriting standpoint. It would be hard to see any concentration of financial clout, I suppose, in the agency or brokerage business from a noncompetitive standpoint.

The CHAIRMAN. But you're looking at it from an agent's standpoint. I'm asking the question in terms of the companies. I'm not asking in terms of the bank employees, but when Prudential buys Bache, when Sears has very large Sears Savings Banks and so on, it's like I said at the outset, it flows both ways. You're correct in terms of the agency force, the number of agencies are very, very competitive. I know full well how competitive it is.

I'm talking about at the top. You also find that there's some great diversity of opinion between some of your companies and your attitudes as those out in the field.

Mr. OSBORNE. Mr. Chairman, that's one of the concerns that I think that we have and you stated earlier that the small banks would be in jeopardy, I think, if the insurance industry is a large industry. There's a lot of money in it and if banks are permitted to write insurance, that's going to aid the big banks to get bigger. The littler banks won't really have the advantage of the expertise or won't have that much clout against the big ones. So this seems to me the big get bigger and the little ones pay the price and I'm certainly opposed to that.

The CHAIRMAN. Well, I understand. Again, my point is, the point you just made can apply to other segments of the industry—securities and the insurance companies, as well. The big get bigger and the little can get littler.

My point is simply that we're trying to achieve a balance that does not allow concentrations and that's why a controversial provision in this bill which you are not addressing and, of course, the bill goes far beyond the section you're concerned with—it talks about not the 25 largest banks, but the 25 largest institutions, and tries to put some restraints in there from allowing any—with regard to what it is—the 25 largest institutions from certain concentrations, certain percentage of their assets in buying others out. That's what I was driving at. The principle applies to any of the industries involved, not just to one.

Mr. CUSTIS. Mr. Chairman, we are fearful of anything that would lead to a few large financial conglomerates, whether they be Citicorp, Prudential-Bache, American Express or whatever.

The CHAIRMAN. Gentlemen, I appreciate your testimony today.

Senator Hecht, before we release this panel, would you like to make any comments?

Senator HECHT. Thank you, Mr. Chairman. I'm sorry I had a conflict with another committee so I understand all the questions we had have been answered. Thank you very much.

Mr. WOODS. Mr. Chairman, we particularly appreciate your earlier comments that it's important to bring this issue up on the top of this table and we are very grateful to you for the opportunity to appear. Thank you.

The CHAIRMAN. Thank you. I want you to know that just because Ken and I are both from Utah and both bald, there are people who have hair in Utah. [Laughter.]

We have a second distinguished panel, composed of John B. Carter, on behalf of the American Council of Life Insurance; president and chief executive officer, the Equitable Life Assurance Society of the United States; Jack Moseley, on behalf of the American Insurance Association; chairman of the board, United States Fidelity and Guaranty Co., Baltimore, Md. I might just divert for a minute to thank Mr. Moseley for his efforts in another area totally divorced from this. The Banking Committee does have other responsibilities besides the banks. It's the Banking, Housing, and Urban Affairs Committee and we are very much involved with housing policy in this country and particularly a program that I have had a great deal to do with for a long number of years, neighborhood housing services, which has worked very well, rather remarkably well, on a small budget compared to a lot of other HUD programs. And Mr. Moseley has been very active in the neighborhood housing services program in Baltimore and has made a very sizable gift of his own plus he spearheaded the fundraising drive. For those of you who don't know, the beauty of neighborhood housing services is it's a cooperative agreement between the Federal, local government, local industry, and the private sector, and it's provided a lot of good housing in a lot of cities and so I just wanted to—although it's totally divorced from this hearing, Mr. Moseley, I wanted to take the opportunity to thank you for your work in the housing field in Baltimore.

Mr. MOSELEY. Thank you, sir.

The CHAIRMAN. We also have Mr. Bradford W. Mitchell, vice chairman of the board, National Association of Independent Insurers; chief executive officer, Harleysville Mutual Insurance Co., Harleysville, Pa.; Donald P. Kennedy, president, American Land Title Association; president, First American Title Insurance Co., Santa Ana, Calif.; and Mr. James E. Jones, Government affairs representative, Alliance of American Insurers.

Mr. Carter, would you like to begin?

STATEMENT OF JOHN B. CARTER, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE; PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, NEW YORK, N.Y.

Mr. CARTER. Thank you. My name is John Carter and I am president and chief executive officer of the Equitable Life Assurance Society of the United States. I am appearing today on behalf of the American Council of Life Insurance, the principal trade association for life insurance companies. The council has a membership of 598 stock and mutual companies which account for approximately 95 percent of the life insurance in force in the United States.

Mr. Chairman, I appreciate the opportunity to appear before this committee to discuss concerns of the life insurance business relating to banking deregulation and, more particularly, the position of our business with respect to S. 2181 and S. 2134.

Many of the points that we intended to make this morning were covered by Mr. Woods. We thoroughly endorse his commentary and I will to cut my oral remarks roughly in half in view of Mr. Woods' testimony.

We oppose both the bills in question because we believe they give expanded financial service powers to banks. Banks are unique institutions occupying a unique position in society and should be prevented from having additional powers that will allow abuses that we will cover in a few minutes.

The bank regulatory structure in this country has had a spectacular success as has been pointed out, Mr. Chairman, and we do not believe it should be changed.

REAFFIRM SUPPORT OF TITLE VI OF THE GARN-ST GERMAIN ACT

We'd like to reaffirm our support for title VI of the Garn-St Germain Act which generally proscribes insurance activities by bank holding companies. We do not believe that events in the last 15 months since that act was enacted support any change in that well-considered position.

Nevertheless, we are daily bombarded by statements from banking representatives that deregulation is inevitable because banks are no longer competitive and because consumers are knocking down the doors of Congress demanding expanded banking powers. Neither of these assertions is accurate.

It is true that a near record number of banks failed last year but we do not believe that they failed for reasons other than making poor investments, unsound loans—particularly in the energy area—self-dealing, and general mismanagement. The banking industry as such did not lose its share of the market in the last few years to other financial service providers. Banks, incidentally, are quite profitable, and we do not find them a source of pity in the business community. That may be further emphasized by the fact a number of foreign banks have made moves to establish U.S. beachheads. Certainly, no one wants to move into an environment that does not offer very attractive profits.

The assertion that the consumers are demanding deregulation we believe is equally false. Consumers have a lot to lose. I think this committee heard a great deal of concern in this regard in the testimony before it last week by consumer groups.

The issue of credit leverage has been mentioned previously by many of the witnesses before this committee. Despite the current law prohibiting tie-ins, tie-ins are a fact. I think the materials referred to by Mr. Woods compiled by Thomas E. Wilson on behalf of a number of insurance agent groups is an extremely relevant piece of work. I highly recommend it to this committee. It is so well written that I would even say that a brief skimming of it would produce a compelling picture of the abuses in the credit life insurance business today.

Just to cite one example from Mr. Wilson's piece of work: there were four banks in question, each of which had 100-percent penetration of its loan portfolio by credit life insurance which it sold. There's some question as to whether each of those thousands of loans really needed credit life tied to it. An additional question, since each of those credit life cases was written by the lending bank, was whether or not in 100 percent of those cases that particular bank was the best source of insurance for that particular consumer. I think my answer is no in both cases.

The occurrence of tie-ins is virtually impossible to prevent. It may not be the result of overt coercion on the bank's part but, as has been pointed out earlier, the need for the borrower to ingratiate himself with the lender compels the borrower to engage in otherwise imprudent dealings. The availability of credit life insurance at the lending bank just compounds the abuse.

I should mention at this point that S. 2181 does endeavor to address some of our concerns in the area of credit leverage. We do not believe, however, that the bill would be effective in the general conduct of business, particularly for customers whose banking relationship involves periodic extensions of short-term credit.

Far from providing consumer benefits, the combination of credit leverage with a greatly expanded range of financial services and the resultant concentration of economic power suggests to us the possibility that individuals might become virtual economic hostages to their banking institutions.

S. 2134 is a much less ambitious proposal, but one which still has as its basic objective the dismantling of the time-tested barriers between banking and commerce. Ultimately, it makes no difference whether the safeguards separating banking and commerce are first removed in the securities, real estate, or insurance areas. Once a breach has occurred in any of these areas, the quantum leap will have taken place, and adding additional items to the laundry list will be mostly pr~~o forma.~~

On the positive side, Senators Heinz and Dodd introduced S. 2072 which would close the so-called South Dakota loophole. We think the recent action by the Federal Reserve has diminished the need for this legislation; however, we feel this bill is worth your careful consideration and believe that the closing of loopholes rather than their ratification is the appropriate course for Congress to follow.

There's also the need to consider the Bush task group on financial regulation and its current report. I believe that report should form an important part of the considerations of this committee.

We believe the problems of effectively regulating the banking industry should be solved before additional layers of complexity are heaped upon the problem.

Mr. Chairman, I will conclude these brief remarks by reiterating that banks are unique institutions. They enjoy special privileges and protections. There is no credible evidence that suggests that their continued viability hinges on their obtaining authority to conduct a broad array of additional financial services. We do not believe that the public would be well-served by such changes.

I want to thank the committee for giving me the opportunity to testify and I'd be happy to answer any questions members might have.

[Complete statement follows:]

STATEMENT OF THE
AMERICAN COUNCIL OF LIFE INSURANCE

Before the

COMMITTEE

on

BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

on

FINANCIAL SERVICES INTEGRATION

March 6, 1984

Statement Made By:

John B. Carter
President and Chief Executiv
Officer
Equitable Life Assurance
Society

Mr. Chairman and Members of the Committee, my name is John Carter, and I am President and Chief Executive Officer of the Equitable Life Assurance Society of the United States. I am appearing today on behalf of the American Council of Life Insurance, the principal trade association for life insurance companies. The Council has a membership of 598 stock and mutual insurers which account for approximately 95% of the life insurance in force in the United States.

I appreciate the opportunity to appear before this Committee and present the Council's views on the important issues confronting you concerning the deregulation of this nation's financial institutions. Particularly, we will focus on S. 2181, the proposed Financial Service Competitive Equity Act and S. 2134, the proposed Depository Institutions Holding Company Act, either of which, if enacted, would fundamentally redefine the role of banking in the financial service marketplace.

Proponents contend that the changes contemplated in S. 2181 and S. 2134 are inevitable because banks are no longer competitive and because consumers are pounding down the doors of Congress and the state legislatures demanding expanded bank powers. We find little validity in either assertion for reasons which will be discussed below.

The key factor to keep in mind, however, is that despite any of the rhetoric, it is still up to Congress and only to Congress to decide when and where any changes in the banking regulatory system will take place.

The task of the Congress in considering these issues is certainly formidable and the consequences of your decisions are of immense importance to all commercial enterprises and particularly to financial intermediaries and the consuming public. As you proceed, I urge you to bear in mind that our present financial regulatory system evolved as a result of the thoughtful work of legislators who were cognizant of the magnitude, complexity, and implication of these issues. Because the existing system of regulation has been carefully crafted and has served us well over the years, it must not be dismantled hastily or without ample justification. This justification must be convincingly demonstrated by the proponents of change, and the consequence of such change must be thoroughly understood before change takes place.

Banking and Insurance

One of the more significant deregulation proposals being considered, and one which is presently reflected in S. 2181 is to permit banks to enter the insurance underwriting and brokerage businesses.

Mr. Chairman, I must point out that it is bewildering that this issue should even be before the Congress given the fact that it specifically considered the historic separation of banking and insurance in 1982 and, as reflected in the Garn-St Germain Depository Institutions Act, concluded that it should be preserved. Title VI of that Act explicitly prohibits bank holding companies and their subsidiaries from engaging in the business of insurance except in narrowly limited, clearly specified instances. The life insurance industry strongly supports this law and its underlying principles, and does not believe that events since the bill's enactment two years' ago warrant any change in policy. While there are some few life insurance companies that are seeking to take advantage of imprecision in the law to gain access to certain banking capabilities, the industry as a whole is not in favor of sweeping changes that would discard the protections against the integration of banking and insurance. If the industry's view was predicated on the simple notion of avoiding additional competition, your job would likely be much easier. It is not. There are important public policy considerations discussed below that dictate against abandoning the present separation of banking and other forms of commerce. It is these public policy considerations that I urge you to use as your compass in determining the direction legislative change should take.

Uniqueness of Banks

In touting deregulation, some bankers have argued that they should be allowed to compete in the financial services marketplace like other competitors. But the fact is that banks are different from any other kind of enterprise. They play a unique role in helping to assure the basic liquidity of our economy, in serving as the link between the central bank and in implementing monetary policy. They have been granted special privileges by the federal government in the form of FDIC insurance, access to the Federal Reserve discount window and various tax advantages. Because they are the primary source of credit for individuals and small businesses, they have unique power over the economic well-being of American consumers. So when banks petition Congress to permit them to enter new markets from which they have been barred by long-standing federal policy, they do not do so as just another competitor.

In deciding whether banks should be permitted to enter insurance or any other new business, Congress should consider the effect of the potential new business on the unique role banks do in fact play in our economy. It is proper to place on the banks the burden of proving that without such sweeping new powers, the banking system could not continue to serve its vital and unique function. Only then should Congress sacrifice decades of safeguards and restraints at the altar of deregulation. We do not believe that the banking representatives have made that case.

There is a conflict between the traditional role of banks and the tough competition which all parties concede is and should be part of the financial services marketplace. The ability to compete necessarily involves the possibility of failure. As Henry Kaufman of Solomon Brothers recently noted, "When you encourage the entrepreneurial drive of the banks, the only way that drive can be disciplined is by allowing banks that have behaved improperly to fail." Yet the history of banking and its regulation in this country makes it clear that the public does not want the banking industry to fit into a framework that tolerates business failure. Past experience with widespread banking failures at times of financial panic has caused the public to place a high premium on a stable banking system in which general economic dislocation and personal losses arising from such failures are held to a minimum. In this regard, the existing limitations on commercial activities in which banks are allowed to engage have served the public well. The public wants and needs a banking system which will always provide both a quick and efficient means of making payments, available on demand, and an assured backup source of liquidity to business and the public at large. The public does not have the same interest in being able to buy insurance from banks, as we shall see.

While we are all beginning to talk in terms of a broad "financial services marketplace," it is important to remember that, though the businesses which make up this marketplace are converging, insurance, banking and securities remain, for the most part, different businesses. They require different kinds of expert knowledge, different training, and different skills. Competitors who have thrived in one part of this enormous marketplace won't necessarily do well in another.

Safety and Soundness

One result of allowing banks to enter heretofore prohibited areas of commercial activities is a pyramiding of risks. Like the banking industry, each segment of the insurance industry, securities industry, and real estate industry presents its own set of risks. Broadly speaking, these risks are quite substantial and are, for the most part, unique to each industry.

We do not suggest that, taken individually, these risks are significantly greater than those that might be assumed by a particular bank in the conduct of its normal banking business. It is a fact, however, that neither banking institutions nor bank regulators have any substantial experience with the various risk management disciplines required by these activities. Speaking specifically about insurance, the combination of banks and insurance companies would certainly lead to a pyramiding of familiar and unfamiliar risks, and this fact would hold true whether the activities were conducted directly or through subsidiary structures. Such an amalgamation of risks poses a serious threat to the stability of the nation's banking system and the safety and soundness of both the banks and the financial intermediaries with which they are affiliated.

The various legislative proposals that would authorize bank entry into insurance and general securities activities seek to limit any resulting increase in risk to the banking function by requiring that nonbanking services be segregated in separate subsidiaries of the holding company. Unfortunately, this legal contrivance does not really address the problem effectively. The issue was succinctly articulated in the 1982 Annual Report of Federal Reserve Bank of Minneapolis which states that segregation by subsidiaries is "...not likely to produce a situation in which the bank is immune from the problems, risks, or losses that might develop in such subsidiaries. In short, the holding company structure is neither a substitute for prudent management nor a fail-safe device for containing risks." Certainly, the concept of conducting banking and insurance within the same legal entity, as has been advanced by some segments of the banking industry, would greatly accentuate these inherent risks.

The passage of time has neither eliminated nor diminished the possibility that severe problems of the type we experienced in the 1920s and early 1930s could reoccur. It is indeed surprising that banks are urging that the restrictions on their investments and their nonbanking activities can be discarded at the very time that they have just experienced their highest failure rate since 1939. Forty-eight banks failed in 1983, many of them as a result of poor investments, unsound loans, particularly in the energy area, self-dealing, and general mismanagement.

Moreover, larger banks have hardly been immune to management error; witness the debacle of bank-sponsored real estate investment trusts in the 1970s and the more recent experience with unrealistic assumptions on the viability of bank credits to developing countries. These failures and related problems were not, as some segments of the banking community contend, a result of banks losing market share or being at a competitive disadvantage in the financial services marketplace. There is nothing in recent banking experience which suggests that the time-tested safeguards and limitations on the powers and operations of banks have imperiled their profitability. To the contrary, a recent article in the American Banker notes that the number of foreign banks establishing offices in the United States to take advantage of banking opportunities has increased for the third year in a row--surely they would not be making such an effort to enter a "dying" market. In addition, the average annual return on equity of domestic banking institutions for the period 1970-1979 compared to that for 1983 has remained virtually the same. These developments hardly suggest that banks and their traditional markets are being squeezed out by nonbanking competition.

In fact, if one looks again at the statistical base compiled by the Federal Reserve Bank of Minneapolis for its 1982 Annual Report, there are some striking revelations. Adding the share of total financial assets held by commercial banks in 1956 to that held by of savings institutions for the same year (the earliest year for which data are available) produces a combined figure representing 62% of the total for all financial institutions. The comparable figure for 1982 represented 60.1% of the total--hardly a significant decline.

Actually, the combined share of assets held by these institutions, increased from 58.1% in 1969, the midpoint of the table and prior to the alleged intrusion by non-depository institutions. There was a marked shift within the 60.1% share for 1982, but this shift was between commercial banks and savings institutions. In 1956 the split was 45.9% banks, 16.1% savings institutions; in 1982 the split was 37.0% banks, 23.1% savings institutions.

Looking at other figures contained in the report, we see that banks alone had the identical 37% share of the market in 1982 that they had in 1966. Insurers over the same period have experienced a substantial drop in market share from 21.3% to 16.9%. Thus, we can see that banks are not losing their share of the market at all, much less to insurance companies. In fact, there is no credible evidence suggesting that either the safety and soundness or the competitive health of banking institutions rests on the expansion of their powers and entry into the field of insurance.

Credit Leverage

I'm sure that the members of this Committee have heard all of the concerns about the use of credit leverage or tie-ins by banks many times before. We continue to raise this issue because it is a persistant problem, despite current laws prohibiting tie-ins, despite the limited nature of currently permissible insurance activities by banks, and despite the extensive system of regulation in most states, developed over a period of years, which is applicable to credit insurance sales.

Bank customers are in such an inferior bargaining position when they come seeking extensions of credit that they are extremely susceptible to the suggestion, either expressed or implied, that they might be more likely to get a loan if they agree to purchase additional bank services, such as insurance. In such situations, consumers are not concerned with the price or quality of the bank's insurance product, they simply want to protect their source of credit.

Thus, even with the extensive system of regulation of credit insurance in most states, instances of excessive zeal in the marketing of that coverage continue to arise. In 1981, Mercantile Bank Corporation, Inc. and Commerce Bankcshares, Inc., two of the largest bank holding companies in Missouri, sought prior approval from the Federal Reserve Board to engage as agents in the sale of property and casualty insurance. The record from the hearing in that application revealed that both bank holding companies had average credit life/loan penetration rates in excess of 60%. Numerous bank subsidiaries of both companies had credit life penetration rates in excess of 80%. Four of Commerce's thirty-eight subsidiaries had credit life penetration rates of 100%. Memoranda from Commerce's insurance subsidiary to the CEO's of Commerce's Banks detailed the persistent pressure placed on Commerce employees to use extraordinary steps to sell credit life and credit disability insurance. Based on this record the Administrative Law Judge concluded that both bank holding companies had been guilty of tying sales of credit life insurance to extensions of credit.

The Federal Reserve Board's own study of credit leverage indicated that nearly two-thirds of bank borrowers purchase credit life or health insurance. And over 40% of those who purchase such insurance do so because they believe it is "required" or "strongly recommended."* How many more agree to purchase such insurance simply because they believe that it will improve their chances of getting a loan?

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* "Tie-ins Between the Granting of Credit and Sale of Insurance by Bank Holding Companies and Other Lenders;" Federal Reserve Board Staff Study, Eisenbeis & Schweitzer (1979).

S. 2181, while making a well-intended effort to deal with the issue of credit leverage still falls well short of the mark. Among other things, Section 107 provides that banks may solicit insurance purchases only after credit approval is given; must inform consumers that they may purchase insurance from whomever they please and must give consumers a 30 day cooling-off period. What these provisions fail to recognize is that protecting the credit life line is much more important to the average loan customer than any other aspect of the loan transaction, perhaps even including the interest rate. Relative to the amount of the loan, the price of credit insurance is not high. Thus it is a small price to pay for ingratiating oneself to the lender. Similarly, while a 30 day money-back guarantee might be appropriate on a tangible item of purchase which the consumer would use during the time period, it makes little sense when dealing with an insurance policy which would be filed away as soon as the consumer gets home. What event would trigger a return of the policy?

Unsophisticated first-time or one-shot borrowers could benefit to a degree from the provisions prohibiting insurance solicitation until after credit approval, but customers who require periodic extensions of short term credit will know the score and act accordingly. The human element in the credit leverage problem is not easily amenable to solution. That is why we have said in the past that the mere offering of additional services by a bank may be inherently coercive to its credit customers.

I think the issue is best summed up by a quote from a recent article on the effects of banking deregulation on the consumer in Best's Review by Ralph Nader. Mr. Nader said: "The ability of banks to sell insurance to consumers who are in the process of getting a loan already has been demonstrated by the monstrously exploitive credit life insurance scam."

Concentration of Economic Power

United States history has been marked by periodic popular outbursts against the inordinate exertion of economic and political power by large banks in eastern money centers. This sort of concern has been a contributory factor in developing the legal and regulatory framework for the banking industry.

Given this past background of popular concern about banking power, the recent aggressive efforts of Citicorp and other banking organizations to achieve a rapid, general dismantling of the traditional system of U.S. banking regulation would seem to warrant a pause for general Congressional stock-taking before this process is allowed to proceed further. The notable successes of large bank holding companies in influencing recent regulatory and legislative activity at both federal and state levels already attests to their substantial economic and political power, witness the rollback of interest withholding provisions and the passage of the South Dakota banking bill. If existing restrictions on banking institutions' activities are relaxed, the prospect for expanded political influence by these institutions will be substantially enhanced.

An economic forecaster recently suggested that the current deregulation process will result in "50 major [financial] institutions, of which two dozen will be collossuses as opposed to 5,000 to 8,000 that we have presently."*/ An executive at Coopers and Lybrand opined "I can easily conceive there being trillion dollar banks."**/ A study published by Arthur Andersen and Company predicts that a third of the Nation's banks, mostly smaller ones, will disappear by 1990. Those banks remaining will be significantly larger. In fact large banks (those with over $1 billion in assets) will control over 65% of total banking industry assets (a 20% gain.)***/

On the other hand, the number of life insurance companies has more than tripled since 1950 while the market share of new business of the 8 largest firms has dropped by almost 50%.

By all of the standard measures of market performance, including price (the price of life insurance has declined steadily for the last thirty years and is now on the average 15% lower than it was in 1955) and profitability (in the low to moderate range compared with other industries), the life insurance business can accurately be characterized as a highly and increasingly competitive business.

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*/ Statement of Arnold Moskowitz, First Vice President and Economist, Dean Witter Reynolds; Wall Street Journal, July 1, 1983, p. 7

**/ Ibid. Statement of John Kneen, Vice President, Coopers & Lybrand.

***/ New Dimensions in Banking: Managing the Strategic Position, Arthur Andersen & Company, July 1983.

One of the most significant manifestations of increased competition within the insurance industry is the dramatic product innovation we are now witnessing. Life insurance companies are refining existing products and developing new products tailored to meet the changing needs of consumers. These innovations generally reflect insurance products with enhanced accumulation features and lower commissions, both of which are indicators of aggressive competition.

The Consumer Perspective

One of the most misleading elements injected into the debate over institutional deregulation is the notion that consumers are demanding bank entry into the insurance business.

The proponents of expanded financial service powers point to the movement of savings dollars out of banks and S&Ls and into money market funds as proof of the consumer demand for deregulation. What this really proves is that consumers want to get a market rate of interest on their savings dollars, which is understandable. But this cannot be extrapolated into support for an argument that consumers are also demanding the ability to buy insurance or securities or real estate from their local bank. They are not. In fact, a recent Money Magazine survey found that 66% of those polled either preferred single-service financial institutions or had no preference. That can scarcely be called a mandate for multi-service financial institutions.

The real incentive in the race to proliferate financial services is not pressure from consumers but expected profits. I certainly do not intend to impugn in any way the profit motive. Rather, I am suggesting that consumer dissatisfaction with existing service offerors is not creating the pressure for bank deregulation.

At a recent Congressional symposium on financial services, a representative of the banking industry touched upon what I suspect is a fundamental rationale for deregulation from a banker's perspective. He asserted that if his bank were authorized to compete in the commercial arena in areas such as insurance and could thereby realize added revenues, this would lead to a lowering of interest rates on loans and benefit consumers. Implicit in this concept was the view that the commercial endeavor--insurance in this case--was nothing more than a profit center; perhaps this is understandable since even a bank with an insurance arm would still be fundamentally a bank. However, no regard seemed to be given to the plight of the insurance consumer, and therein lies the fallacy in the argument that banks will be price competitive if permitted to enter the insurance business. The disasterous experience with banks selling credit life insurance described previously gives harsh testimony to this fallacy, and the ability to exert credit leverage merely compounds the problem. Moreover, it is misleading to suggest that bank interest rates are linked to the profitability of individual banks. Interest rates reflect aggregate supply and demand in the market. A bank with an insurance operation is not going to lower its general interest charges simply because its insurance operation proves to be profitable. Enhanced bank profits will remain with the bank or, at best, be passed along to stockholders. Consumers will not be the direct beneficiaries of additional profit centers.

To the extent we have heard consumers discuss at all the issue of integrated financial services, it has usually been in the context of the tremendous burden on the consuming public to understand the increasingly complex world of financial services. It is beyond dispute that these products are becoming more complex, and institutions, regulators, legislators, and of course, consumers must grapple with how effective disclosure regarding their cost and operation is to be provided. The personalized service afforded by the insurance agent to the consumer is a mitigating factor in the problem of understanding financial services. On the other hand, a movement toward bank sponsored insurance services will tend to impersonalize the sales procedure and afford the purchaser less and not more disclosure. This issue can only become more troublesome as financial services integration continues.

The greatly increased risk to the safety and soundness of the banking system, the expanded opportunities for banks to engage in coercive tie-in sales, and an increased concentration of economic power among large banks are all potential by-products of sweeping bank deregulation. Taken as a whole, they portend an environment in which individuals could become virtual economic hostages to their banking institutions.

We are not suggesting that additional bank deregulation will be of no benefit to consumers. We believe, however, that the added benefit to consumers will be substantially less than some allege, perhaps limited largely to enhanced convenience. The real benefits of integrating financial services--the benefits of synergism--may well inure more to the benefit of providers than to the purchasers of those services.

Regulation and Deregulation - A Matter of Priority

A critical but often overlooked aspect of the deregulation debate is whether product deregulation should be permitted to occur before applicable regulatory structures are attuned to a deregulated environment. Some voices advocate deregulating products first so that regulators will know what their scheme of regulation must accommodate. While at first blush, this sounds appealing, it does not hold up under careful analysis. Anyone who has participated in the debate over banking deregulation knows full well the products and services at issue. There will be no surprises on this count. So the real question, then, becomes how one should regulate possible new activities.

And there is strong evidence that dealing with the regulatory structure first is the only means by which serious competitive and economic consequences can be avoided or at least minimized. I should point out that the insurance industry is not advancing this thought as a tactic for delay. Our overall position on the propriety of integrating banking and commerce would remain the same regardless of which development comes first.

Perhaps the most important argument in favor of dealing with regulation first centers on the fundamental contradictions between the public's demand for a stable banking system (and the consequent system of bank regulation with its federal safety net) and the free market theory (with its implicit endorsement of the freedom to fail). Permitting banks to engage in broad commercial activities without first adjusting the bank regulatory system could saddle nonbank entities with unfair competitive burdens since they are in no way protected against failure.

Second, it is indeed doubtful whether existing regulatory systems are capable of dealing effectively with the proposed new powers and structures of those they regulate. Regulators today are having increasing difficulty assuring the safety and soundness of the increasingly complex financial holding companies that are now emerging, with their growing multitude of products and services.

The recent failure of United American Bank of Knoxville, Tennessee and its eight affiliated banks is illustrative in this regard. In assessing the collapse of this enterprise, the House Committee on Government Operations was highly critical of the

FDIC, pointing in particular to the regulator's inability to recognize "a virtually unbroken pattern of unsafe, unsound, and conceivably unlawful bank practices" over a six-year period.

In its defense, the FDIC asserted that the sheer complexity of this banking amalgam "made the identification and assessment of the problems extraordinarily difficult. The present system with its overlapping lines of authority is not conducive to effective supervisory coordination of affiliate banking enterprises in a deregulated, rapidly changing environment."

In one sense this is encouraging, because we see the FDIC at least acknowledging what we have been saying about the difficulties of regulating effectively these diverse financial enterprises. Imagine if you can, the far worse scenario had a bank such as Penn Square acquired Baldwin-United somewhere along the line. And this is not inconceivable in the totally deregulated environment some people are encouraging. The argument that "regulation by function" will largely eliminate these concerns is obviously not well founded.

Finally, it is significant that the Task Group on Regulation of Financial Services, chaired by Vice President Bush, has proposed a major reorganization of the federal agencies responsible for the regulation of commercial banks. Even with this particular set of proposed changes we don't believe the regulators will be able to cope with the new combination of structures and powers. Without these changes it is clear that they cannot provide the necessary safeguards. A complete Congressional review of the issues raised by the Bush recommendations ought to be completed and reform actions implemented before Congress moves to proliferate the functions of the commercial banks.

Legislation

I would like to direct some specific comments toward the legislation pending before this committee.

S. 2181

As I mentioned previously, we support the provisions of Title VI of the Garn-St. Germain Act separating banking from insurance and believe they should be preserved. This puts us unavoidably in opposition to the basic underlying premise of S. 2181 which is that the safeguards between banking and other forms of commerce including insurance should be abandoned.

But beyond such fundamental objections, there are a number of specific provisions in S. 2181 which we feel need to be addressed. For example, a mutual insurer would be permitted to participate fully in banking activities, but only by becoming a bank holding company and thus subjecting itself to dual regulation by Federal banking and state insurance authorities. The potential for duplicative, overlapping and conflicting regulation under such circumstances would be high.

As a result, mutual insurers would be placed at a potential competitive disadvantage relative to other providers of financial services organized in stock form, including stock insurers, who would be able to avoid dual regulation merely by forming an upstream holding company.

Further, under S. 2181, state enabling legislation, such as that passed last year in South Dakota, would permit the conduct of insurance or securities activities directly within a state bank, so long as it applied equally within and without the state. This would undermine the intended protections against co-mingling of assets and insolvency which would otherwise accrue from the use of a holding company structure with separate subsidiaries for distinct activities.

Further, in addition to specific grants of authority, Section 104(d) of the proposal permits bank holding companies to engage in any activity deemed by the Federal Reserve "to be of a financial nature." We believe that is far too imprecise a standard to leave within the discretion of the Federal Reserve, particularly in view of the fact that, once made, the determination is unappealable.

S. 2181 also imposes concentration limitations which work to the disadvantage of non-banking firms seeking to acquire banks. For example, under the guidelines, the largest bank holding companies could acquire all but the four largest life insurers. As a practical matter, however, none of the 20 or so largest banks could be acquired by an insurer.

S. 2134

The Depository Institutions Holding Company Act (S. 2134) introduced by Senator Proxmire is a far less ambitious proposal than S. 2181. It also contains provisions which we favor, reaffirming the prohibitions on insurance activities by bank holding companies contained in Title VI of the Garn-St Germain Act. Like S. 2181, however, its overriding purpose is to expand the range of commercial activities in which banks would be permitted to engage, and for that reason we must oppose S. 2134 as well. Ultimately it makes no difference whether the safeguards separating banking and commerce are first removed in the securities, real estate or insurance areas. Once a breach has occurred in any of these areas the quantum leap will have taken place and adding additional items to the activities laundry list will be mostly pro forma.

Significantly, S. 2134 discards the "public benefits" test currently contained in the Bank Holding Company Act (BHCA) as a check on bank holding company adventurism. Under current law, in order for the Federal Reserve to approve new non-bank activities by a holding company, it must find that some public benefit is likely to accrue as a result of such activities, which outweighs the possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. The elimination of the public benefits test would seem to indicate the belief that these sorts of concerns are no longer relevant in the financial services marketplace. We do not share that view.

S. 2134 also would create a gaping hole in the BHCA by permitting in-state bank holding companies to engage in all activities permitted for state banks, notwithstanding any prohibition on such activities contained in the Act.

This would give rise to just the sort of crazy quilt pattern of bank holding company regulation that the Act was enacted to prevent.

S. 2072

Along those lines there is another proposal pending before this Committee that I would like to mention briefly. S. 2072, introduced last year by Senators Heinz and Dodd, is intended to prevent bank holding companies from circumventing the activities restrictions of the BHCA through state bank subsidiaries, as was attempted last year in South Dakota.

The urgency for passage of this proposal was diminished somewhat by the recent action of the Federal Reserve in suspending the processing of applications to acquire South Dakota banks by a number of large bank holding companies. We believe the Fed was correct in reaching "the tentative judgment that it could not approve the proposed bank acquisitions in view of present law and expressions of Congressional intent subject to any further consideration by the Congress."

While we have some concerns relating to certain grandfather provisions of S. 2072, we applaud the action of Senators Heinz and Dodd in bringing forward this proposal and believe that the closing of loopholes rather than their ratification is the appropriate course for Congress to follow in the financial services area.

CONCLUSION

Mr. Chairman, I will conclude by reiterating that banks are unique institutions that provide essential services to consumers, the business community, and the economy as a whole. They enjoy special privileges and protections. There is no credible evidence to suggest that their continued viability hinges on obtaining the authority to conduct a broad array of additional financial service activities. Furthermore, it is beyond dispute that their credit lending powers give them an inherently unfair advantage in the marketing of nonbanking services.

For these reasons, we do not believe that the public would be well served by legislation to expand banking powers. The most appropriate course for Congress to take would be to reexamine the regulatory structure for depository institutions and to enact whatever temporary or permanent legislation is necessary to preserve its banking reform options while that process is underway.

Mr. Chairman, again I want to thank the Committee for giving me the opportunity to testify. I would be happy to answer any questions the members might have.

The CHAIRMAN. Mr. Moseley.

STATEMENT OF JACK MOSELEY, ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION; CHAIRMAN OF THE BOARD, UNITED STATES FIDELITY & GUARANTY CO., BALTIMORE, MD.

Mr. MOSELEY. Thank you, Mr. Chairman. As you have pointed out, my name is Jack Moseley and I am chairman of the board and chief executive officer of United States Fidelity & Guaranty Co., in Baltimore, but I'm appearing today on behalf of the American Insurance Association [AIA]. The American Insurance Association represents 170 property-casualty insurance companies. Our members account for 31 percent of the market for property-casualty insurance, with written premiums over $30 billion in the United States.

BANKS HAVE NOT MET BURDEN OF PROOF

I am sure it surprises no one, particularly you, that we oppose banks entry into insurance. I would, however, deny that we are obstructionist in so doing. Unlike banks, we are not appearing here today before this committee with a wish list of things that we'd like to have, but rather to point out that the banks have not met the burden of proof, in our opinion, which is on them that there is great consumer demand for the entry into the insurance industry or, in fact, for their entry into several other types of businesses that they would like to be in. We speak only in terms of the insurance business itself.

Like most people, we believe that banks are considered unique and for that special uniqueness they receive special considerations, not the least of which is FDIC insurance.

The public expects, I think, and certainly they have a right to expect, protection and it has been given in past years by Congress in terms of the FDIC, FSLIC insurance, the discount window access that banks have in terms of the lender of last resort, and of course they have the support of the Federal Reserve System.

That is a uniqueness that we certainly do not share in the insurance business and we think it is a uniqueness that should be considered by this committee at all times.

Mr. Corrigan, the president of the Minneapolis Federal Reserve Bank, has said there are other reasons why banks are unique. They have the ability to offer transaction accounts. They are the backup source of liquidity for all other businesses and they have a special role in helping implement national monetary policy.

To give banks broader powers in other industries such as the insurance industry would immediately, we think, create a concentration of financial power that we think is dangerous.

Congress responded to the concern for the solvency of banks early on and for that reason they thought there were significant reasons for the separation of banking from commerce. As regards the testimony and answers that were given by the last panel in terms of whether or not banks failed because of deregulation, Senator, I would say that I think that is somewhat a moot question for the simple reason that in 1983 FDIC paid out $2.6 billion on bank failures and in the 3 years, including 1983, they paid out $5.3 billion. The payout in that 3-year period was more than in the previous 47-year history of the FDIC.

It seems an inappropriate time to give banks expanded powers and certainly not into an area where there is a risk assumption. We insurers have been typed by some people as not being risk-takers but as mere managers of assets. I would disagree with that description of what we are. Certainly if you look at things that have happened in the last several years in the property and casualty industry, not only do we have the usual catastrophic events in terms of hurricanes and bad weather and other things, which can, in fact, if they occurred in normal numbers, be built into the rates, but these events occurred in unusual numbers. That is a straight risk assumption either by the policyholders of a mutual company or the stockholders of a stock company.

But there are other things, such as the huge, inflated losses that occurred and are still being litigated in court in terms of asbestosis and other incidences of that sort. Congress itself was involved in recent history in solving the black lung disease problem which ballooned out of all proportion.

So we think that there's a case to be made that the insurance industry is a risky business. It is a risk assumption business, and on that basis, we believe that the special nature, the special considerations, the special concern about the solvency of the banks should be considered in determining whether banks are to be allowed to be risk assumers.

It has been generally conceded in the past that banks are trustees of public savings and on that basis must avoid risk and should avoid risk. If they are allowed into the insurance business, that consideration would go by the wayside.

Others have spoken on the historical concern with the concentration of economic resources and I will not state anything further except to say that the concern is relevant today. We do agree—the AIA does agree that there is a concern about credit leverage.

We are concerned about the consumer perception in terms of asking for a loan at whatever level and feeling that there might have to be some insurance purchase made because of it. Most people at this point have discussed that question purely in terms of perhaps a personal nature—a home mortgage situation, or homeowners insurance, an automobile loan, or whatever. I submit to you that the leverage and the pressure in the tie-in sale would be much more extreme in the commercial area where one needs a lot of credit. Something that we're particularly familiar with at USF&G are contracting accounts, where contractors need a line of credit in order to perform their work. There could be extreme twisting and leveraging in this situation, far greater than the automobile or the homeowner situation. It would particularly affect small businesses because they are often just starting up and they need that first line of credit. They would be targets for tie-in sales.

AIA SEES TWO ISSUES AT STAKE

In terms of whether or not banks are allowed to be in the insurance business from my perspective and the AIA perspective, we think that there are two issues that are at stake.

One is the sales authority and the other is the underwriting or risk assumption authority. They are different questions, but we believe that both of them are equally risky and that banks should not be allowed to go into either of those areas.

Speaking to the regulatory question, I find that in thinking of the problem, I believe it will be most difficult to have an effective regulatory system in a multiple-regulated industry. I'm not aware of any regulator that would not be nosy and get into the other guy's turf. He would do it by nature if not by simple demand. It is difficult to see how a bank regulator could come to a conclusion on the solvency of a bank if a subsidiary were being regulated by another regulator. I think that what would happen is that you would be regulated by all three regulators, or four, or whatever the number. That would cause the cost of regulation to be enormous and the public still would have a problem.

Finally, I would say to you that, as you've said, Congress did in fact speak to this issue very recently and Congress should not be preempted by State or individual marketplace players. Congress does need to address this question and we strongly urge you to do that.

We commend you for the position that you are taking that it is an issue that should be looked into, but we would hope that the committee would seriously consider limiting banks authority to get into the insurance industry.

Thank you, sir.

[Complete statement follows:]

STATEMENT
OF
THE AMERICAN INSURANCE ASSOCIATION
BEFORE
THE SENATE COMMITTEE
ON
BANKING, HOUSING AND URBAN AFFAIRS

MARCH 6, 1984

PRESENTED
BY

JACK MOSELEY
CHAIRMAN OF THE BOARD
AND CHIEF EXECUTIVE OFFICER
UNITED STATES FIDELITY AND GUARANTY COMPANY

Mr. Chairman and members of the Committee, my name is Jack Moseley. I am Chairman of the Board and Chief Executive Officer of United States Fidelity and Guaranty Company. I am appearing today on behalf of the American Insurance Association. The American Insurance Association represents 170 property-casualty insurance companies. Our members account for 31% of the market for property-casualty insurance, with written premiums over $30 billion.

The American Insurance Association was privileged to testify last June before this Committee in its hearings on problems facing the financial services industry. The Association commended this Committee for its efforts to come to grips with this complex subject. We also noted that the appropriate forum for changing the permissible activities of deposit-taking institutions is Congress and not individual state legislatures. We wish again to add our voice to those calling upon Congress to assume a leadership role in determining the proper regulatory structure for the financial services industry. While we would agree that some changes in the existing framework may be necessary, Congress need not and should not sweep away the basic statutory guidelines that have served the American public and financial markets well.

The major focus of the legislation now under consideration by this Committee concerns what banks will be able to do. One of the things that banks would be allowed to do under your bill, Mr. Chairman, the Financial Services Competitive Equity Act, is engage in the sale and underwriting of insurance. The American Insurance Association opposes the granting of new property-casualty insurance authority to banks. The written statement which we have furnished to the Committee sets forth at some length the basis for our position. I would like to use the time alloted to me for my oral remarks to highlight key points of the Association's position. Further, as a chief executive officer of an insurance company with over $4 billion in assets, I would like to add some of my own thoughts as to why Congress should not allow banks to expand outside the business of banking into other commercial activities.

We realize that there are those who would label our position as obstructionist. However, unlike the bankers, we do not come before you with a "wish list." It is not obstructionist to point out that the burden of justifying expanded powers for banks falls squarely on the banks. That the banks cloak themselves in the mantle of inevitable "progress" and claim to be supported in their quest for new powers by a groundswell of consumer demand should not fool the Congress into granting their every wish. The banks' burden of justifying expanded powers has yet to be met. In the first place, banks seem most interested in insurance powers in order to establish another profit center. Second, banks have yet to demonstrate that competition would be increased to the benefit of consumers, either through reduced prices or enhanced service. Third, in no forum where this issue has been debated have consumers come forward to show their support for banks to enter the business of insurance.

The members of the American Insurance Association have no fear of fair competition in insurance services. Indeed, the public will benefit if all participants play by the same rules with proper safeguards. On the other hand, since deposit-taking institutions are considered unique, and receive special advantages such as federal deposit insurance, these institutions must expect to be regulated in a manner befitting their responsibility to the public and the national economy. At no point should the public responsibilities of deposit-taking institutions be abrogated merely to further the goal of financial deregulation.

Invoking the principle of competition and referring to the efficiencies that will supposedly result from deregulated financial markets is no substitute for the failure to recognize the enormous competitive advantage the banking system in this country has. In the property-casualty insurance industry, fierce competition is a fact of life. If my company does not exercise appropriate care in pricing the risks it insures, we will not be in business for long.

Although competition is the hallmark of my industry, it certainly is not a feature of the banking system. The American people will not tolerate the costs of failure in the banking industry. The public places a high premium on a stable banking system that avoids the personal losses and economic dislocations that would result from the failure of these institutions.

The key public protection against such failures is the federal deposit insurance system. Mr. Chairman, at the same time your bill would permit banks to engage in new and very risky activities, the federal government would be expected to continue to protect the public through the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC). The federal government, depositors and taxpayers would still be responsible for the cost of bank failures, but your legislation would, in the name of competition, weaken the statutory safeguards against risky bank activities that help prevent bank bail-outs.

The advantage of federal deposit insurance is by no means the only distinctive feature of the banking system. As pointed out by Minneapolis Federal Reserve Board President Gerald Corrigan, banks are unique because they (1) offer transaction accounts; (2) are the backup source of liquidity for all other institutions and (3) play a special role in implementing national monetary policy. To fulfill their vital role in the country's economy, banks have access to the federal reserve system for discount funds and as a lender of last resort.

To ensure safety and soundness of the banking system, Congress enacted legislation separating banking from commerce. We believe there are sound reasons for keeping the barriers between banking and commerce intact, especially as they apply to banking and insurance. There are inherent problems in allowing banks to enter the business of insurance. In particular, there are clear dangers of bank insolvency, excessive economic concentration, multiple regulatory conflicts and credit leverage abuse. These dangers strike at the heart of this country's economic system and are the reasons for continuing the current national policy of not permitting deposit-taking institutions to underwrite or sell insurance.

A significant reason for the separation of banking from commerce is concern for the solvency of banks. The number of recent bank failures is unprecedented since the Depression. We question whether new and potentially risky activities should be authorized for the banking industry when it is experiencing obvious problems. Despite the pleas of the banking industry for new powers to add new sources of revenue because their profit margins are being squeezed, this may be the most inappropriate time to authorize new activities that place the capital of the banking system at risk. The FDIC recently announced that it spent a record $2.6 billion in 1983 reimbursing depositors and assisting troubled banks. In the last three years, the FDIC has had to pay out $5.3 billion--more than the total amount paid out in the agency's previous 47 years.

The authority to engage in insurance underwriting would undoubtedly cause further financial problems in the banking industry. It is unfortunate that insurance has been included in your bill, Mr. Chairman, as another "financial service." The insurance business is a business of assuming risks. The banking business, however, is fundamentally different in that banks, as trustees of the public's savings, must avoid risks.

Those who point to the insurance industry as mere "managers of assets" ignore the nature of the risks assumed by the insurance industry and the increasing uncertainty of when a company's exposure to particular risks end.

If a bank purchases an insurance company with a large number of long-term liability risks for which the insurance company has not set aside adequate reserves, who should bear the consequences? For example, should the FDIC be responsible for paying off depositors of a bank that failed due to catastrophic losses incurred by its insurance subsidiary? Or, if the FDIC decides a bank failed because of its insurance activities and therefore refuses to pay off depositors, should the state insurance guaranty funds be responsible for reimbursing the FDIC? Could state guaranty funds and the insurers funding them survive such a tangled web?

Some proponents of deregulation of financial services assert that creating a system of discrete subsidiary operations would sufficiently insulate a healthy banking operation from other business activities that may be experiencing financial difficulties and vice versa. Most bank regulators, however, concede that it may be impossible in time of financial peril to insulate a bank from the problems of its sister organizations. When seen in the context of the entangled Butcher Bank fiasco and the similarly convoluted Baldwin-United debacle, it is not difficult to see how easy it could be for financial problems to flow from one troubled affiliate to another.

Historically, a major concern of Congress in establishing the separation of banking from commerce was preventing the accumulation of too much economic power in the hands of the nation's banks. This concern is still relevant today. Deregulation raises the possibility that banks, utilizing the various advantages they possess as a result of their special status, may make such substantial inroads into other parts of the financial services industry that concentration in the industry will be increased to a harmful degree.

Mr. Chairman, your bill attempts to address the question of excessive financial concentration by barring certain mergers and acquisitions between bank holding companies and companies engaged in insurance securities, real estate or other activities. However, the logic of the provision is flawed because it ignores the ability of bank holding companies to generate large amounts of insurance business through even a small insurance company. Further, it appears that the threshold capital test need only be met at the time of acquisition. Thereafter, the acquiring bank holding company could inject more capital into the acquired entity if it so desired. In short, this provision would not do enough to prevent major economic concentration from occurring. It appears likely that banks would amass even greater economic power than they currently possess.

Beyond the issues raised by permitting banks to place their capital at risk, there is a very real danger of banks being able to use their power to grant or deny credit to induce the purchase of insurance. Although I believe the insurance producers have already made an overwhelming case against permitting banks to sell insurance, I would say that the authorization of insurance sales powers to banks is at least as dangerous, for different reasons, as permitting these institutions to risk the public's deposits in insurance underwriting.

The perception by consumers that the purchase of insurance might improve their chances of receiving a loan cannot be cured by regulation or greater supervision. Of course, I do not believe banks will overtly coerce their customers into purchasing insurance. My concern is that consumers, in need of a loan, will not shop around for the most suitable and least expensive insurance policy, but will feel compelled to purchase whatever the bank offers.

Mr. Chairman, your bill includes a number of consumer protection devices designed to alleviate the tie-in problem. However, protective provisions such as a right of cancellation, notice of the right to alternative insurance choices, and a trade association right of injunctive relief are insufficient to prevent the implicit tie-ins that inhere in a credit transaction where the lender also has the ability to sell an ancillary product such as insurance.

For a number of reasons, including differing accounting procedures, reserve requirements, and overall approach to business, the banking and insurance industries are very different. Therefore, regulatory techniques and requirements are different. Regulation across industry lines of banking and insurance by different agencies invites regulatory turf battles. Some have suggested that the answer is to have "regulation by function," in which, for example, insurance regulators would regulate insurance activities, even if they were conducted by a bank subsidiary, and vice versa.

This is good, so far as it goes. Keep the bank regulators regulating banking and the insurance regulators regulating insurance. Indeed, as recent bank failures such as United American Bank of Knoxville have shown, the numerous bank regulators have their hands full trying to detect fraud and unsound financial conditions in the banking system with respect to banking activities. Their task would be considerably complicated if they were expected to regulate bank activities in the insurance industry, which is subject to different business practices, investment policies, guaranty fund requirements and consumer protection mechanisms. Similarly, insurance regulators would have to reorient completely their regulatory procedures to be able to regulate banking activities adequately.

Is regulation by function realistic? We do not believe so. Notwithstanding how difficult it would be for regulators to readjust to regulating a new industry, it is neither practical nor wise to expect regulators of one aspect of the financial services industry, such as insurance, to ignore the potential impact of a regulated entity's operations in another area, such as banking, when there is such a high likelihood of crossover problems. However, it is exactly this large potential for the spread of financial difficulties across corporate lines that would undoubtedly lead to conflicts among regulators. In short, to allow banks into other regulated industries invites regulatory chaos.

Although most of the debate concerning financial services deregulation has focused on Congress, on federal statutes such as the Bank Holding Company Act, and on federal regulators such as the Federal Reserve Board, certain proponents of expanded bank powers continue to attempt to have legislation introduced at the state level in an attempt to circumvent federal law and policy regarding permissible bank activities. South Dakota has already enacted a law that, in giving state chartered banks the power to engage in all facets of the insurance business and blatantly inviting out of state bank holding companies to acquire such banks, directly undercuts the Bank Holding Company Act and thus attempts to override the ability of the federal government to regulate the nation's banking system.

Although recent actions of the Federal Reserve Board have temporarily closed the alleged "South Dakota loophole," other states may yet succumb to the temptation to engage in their own version of bank deregulation. The clear danger is that individual states, in their haste to outdo one another, will engage in a "race to the bottom" in the regulation of financial institutions in hopes of attracting new business to the state. This process is detrimental to the national interest in a stable system of bank regulation.

As respects the specific legislation that the Committee asked us to comment upon, we must state our general opposition to both the Financial Services Competitive Equity Act and the Depository Institutions Holding Company Act. The American Insurance Association finds the proposed Competitive Equity Act legislation objectionable because it would largely eliminate the barriers between banking and commerce. Significantly, banks would be allowed into the insurance business. For all the reasons that I have discussed, this is unacceptable. Although the bill attempts to solve the credit leverage and financial concentration problems, it falls short. Finally, the bill is objectionable because, due to their inability to form an upstream holding company, mutual insurers would be subject to dual regulation by state insurance and federal banking authorities and would thus be placed at a competitive disadvantage vis-a-vis stock insurance companies.

With respect to the proposed Depository Institutions Holding Company Act, we note that while the bill would reaffirm the prohibitions on insurance activities by bank holding companies contained in Title VI of the Garn-St Germain Act, it would allow such activities if they are performed exclusively within a state for residents of that state. This seems to us to be an inconsistent implementation of the policy of separation of banking from commerce that we cannot support.

Conclusion

However powerful the forces changing the financial marketplace are, they must still be subject to regulation if economic chaos is to be avoided. While some changes in regulatory structure may be inevitable, necessary and even welcome, Congress should not discard the concept of the separation of banking from commerce that has helped safeguard our economic system for many years.

Mr. Chairman, I appreciate the opportunity to appear here today and I would be pleased to respond to any questions you may have.

The **Chairman**. Mr. Jones.

STATEMENT OF JAMES E. JONES, GOVERNMENT AFFAIRS REPRESENTATIVE, ALLIANCE OF AMERICAN INSURERS

Mr. **Jones**. Thank you, Mr. Chairman.

I am James E. Jones, Jr., government affairs representative of the Alliance of American Insurers, a national association of 170 property and casualty insurance companies doing business in all 50 States and the District of Columbia.

We very much appreciate this opportunity to provide the committee our views on the integration of the financial services industry. We congratulate the chairman and the members of the committee for providing a forum for consideration of the changes taking place in the financial services markets.

The alliance testimony today will deal mostly with title I of S. 2181. Mr. Chairman, we will summarize our prepared statement and request that the full text be placed in the hearing record.

As a matter of broad public policy, the alliance is not opposed to competition from depository institutions. The alliance and other companies believe in competition as it generates innovation, stimulates quality service, and helps to control price.

Philosophically, the alliance encourages competition in insurance and believes that such competition is in the best interests of policyholders, insurers, regulators, and the public generally. However, we do believe that competitors must be regulated equally and that no competitor should be permitted an unfair advantage.

Therefore, we are opposed to its enactment. If these issues are dealt with in a distinct and precise manner——

The **Chairman**. Mr. Jones, could I stop you right there on that specific point? I understand your feelings about insurance. Would you extend that to the entire range of S. 2181 rather than the specifics of the title that affects insurance? You are opposed to the entire bill? Are you familiar with the entire bill or all of you that there are things that have absolutely nothing to do with insurance?

COMMENTS CONCERNING TITLE I OF S. 2181

Mr. **Jones**. Our comments are just to title I, Mr. Chairman.

The **Chairman**. I wanted to make that clear. You said you were opposed to the enactment of S. 2181. I hope you would not extend that past the title that you're opposed to. I wanted to make that distinction. I understand where all of you are coming from, but please don't extend it to a whole range of other things. Thank you for the clarification.

Mr. **Jones**. It's to the insurance section, the underwriting section in title I, Mr. Chairman.

If these issues are not dealt with, competition would become unequal. The safety and soundness of insurers and banks would diminish and policyholders and the general public would be harmed.

The alliance supports a level playing field, which means that competitors must conform on a uniform basis to relevant laws and regulations and that consumers must be protected not only from coercive activities but also from losses resulting from insolvencies. Achieving a level regulatory playing field on which the different types of financial institutions can compete equally has been widely supported by both public officials and by participants in the industries involved. It appears, however, that public utterances and private feelings are often at odds with each other. Each industry seems anxious to obtain its own advantage when its firms enter new financial service activities while at the same time maintaining its present advantages when firms from other industries seek to enter its preserve. All businesses must be subject to the same regulatory ground rules if they are to compete in the same areas.

S. 2181, however, leaves a number of questions unanswered.

The first question to be considered is: Who will regulate an organization that does both a banking and insurance business? Banks are presently regulated by a combination of State and Federal regulators and insurers by State regulators. The question is: Who will regulate the insurance function of a bank? Parity of regulation between conventional insurers and those affiliated with banks is paramount.

We strongly believe that only the State should regulate insurers activities and powers. However, under title I of S. 2181, every bank holding company that wants to get into the insurance business without turning all of its banks into consumer banks will have to submit to some regulation of its activities by the Federal Reserve Board. Since mutual insurers cannot establish upstream holding companies, they should be allowed to establish downstream holding companies that can underwrite insurance with the downstream holding company rather than the mutual insurer defined to be a bank holding company. This problem is dealt with in greater detail in our prepared text, Mr. Chairman.

A second set of questions relates to unfair trade practices. There must be consideration of the potential for unfair trade practices. Commercial banks, because of the special leverage associated with their lending power, are in a position to suggest to their credit customers that it is in the customer's best interest to use other services offered by the bank. Of even greater significance is the coercive atmosphere surrounding the credit transaction. The perception many customers and business people have that their chances to receive a loan or continue their line of credit will improve if they purchase insurance from the lender or the lender's affiliate. This type of subtle coercion, instead of creating competition, stifles it by eliminating product quality and price as considerations in the consumer's purchasing decision. Effective deterrents to such pressure must be found. Broadened entry of banks into insurance and other nonbanking areas could easily exacerbate this leverage problem.

SERIOUS POTENTIAL FOR COERCIVE ACTIVITIES

Section 107 of S. 2181 borrows from the National Association of Insurance Commissioners' model insurance unfair trade practices act. We believe that this is one approach to control the serious potential for coercive activities.

The alliance does propose that the antitie-in and anticoercive provisions be extended to cover all thrifts as well as the banking institutions.

How are insolvencies handled involve a third series of questions. There could be conflicts created by the extension of multiple insolvency fund systems. How will the FDIC and State insurance property and casualty insurance solvency funds interrelate if banks enter the insurance business? Will reinsurance purchased to protect against certain risks be considered assets of the bank and thereby subject to claims by bank creditors? There must be a segregation of assets, liabilities and reserves, so that should an insolvency occur, one could be assured that the assets which back up certain portions of the business are in fact attributed to that portion.

The corporate structure of an integrated financial service institution needs to insure that assets meant for the protection of one set of customers may not be transferred to others. Unless assets are prohibited from being transferred from one institution to another, insolvency of an integrated financial service institution with insurance, banking and securities business, would trigger participation of all the various protection funds. This would create impossible situations.

Fourth is the question of accounting. Banks generally use GAAP accounting. Insurance companies use the more conservative accounting prescribed by the National Association of Insurance Commissioners in the Annual Statement filed with all States. This method attempts to insure that an insurer's assets are always sufficient to cover its liabilities. Using the NAIC annual statement method of accounting is essential for insurance purposes in order to protect consumers against insurance company insolvencies.

Insurance underwriting is a unique business. The true cost of insurance is not known until after the sale has been consummated, after the loss has occurred. Therefore, it is necessary that this fact be taken into account as is being done today through the statutory accounting method which State insurance regulators have to have. The alliance is firmly convinced there are a number of issues that must be resolved before banks are permitted into the insurance business.

Equity of competition requires that regulation be equal. For such a level playing field to be achieved, the following criteria must be adopted. These areas that we feel are important and should be dealt with are regulatory equity, unfair trade practices, insolvency protection, the accounting differences, inherent advantages that the banks have by being able to borrow from the discount window, corporate structure which the bill speaks to that affiliates work through separate corporations.

If S. 2181 were amended to meet these criteria, the alliance would withdraw its opposition to the bill. Mr. Chairman, the more we learn about the banking industry, the more we discover we do not know. The alliance staff continues to study the banking field in order to learn so that we can continue to assist the committee and its staff in developing compatible legislation.

The alliance must oppose the insurance section S. 2181 at this time since it fails to meet the criteria which the alliance has developed to insure that integration of financial services will insure a truly competitive marketplace. We are prepared to continue to work with you, committee members and the staff, Mr. Chairman.

Mr. Chairman, we again thank you for this opportunity to present our views concerning the entry of banks into the insurance business as underwriters. We will be pleased to answer questions.

[Complete statement follows:]

STATEMENT OF THE

ALLIANCE OF AMERICAN INSURERS

I am James E. Jones, Jr., government affairs representative of the Alliance of American Insurers, a national association of 170 property and casualty insurance companies doing business in all fifty states and the District of Columbia.

We very much appreciate this opportunity to provide the Senate Committee on Banking, Housing and Urban Affairs our views on the integration of the financial services industry. We congratulate the Chairman and the members of the Committee for providing a forum for consideration of the changes taking place in the financial services markets.

Philosophically, the Alliance encourages competition in insurance, believing that such competition is in the best interests of policyholders, insurers, regulators and the public generally. However, we do believe that competitors must be regulated equally and that no competitor should be permitted an unfair advantage.

S.2181, the "Financial Services Competitive Equity Act of 1983" does not meet specific criteria we believe is necessary to provide such "equal level regulatory playing field" and therefore, we are opposed to its enactment. If these issues are not dealt with, competition would become unequal. The safety and soundness of insurers and banks would diminish and policyholders and the general public would be harmed.

The Alliance believes in a "level playing field." This means that competitors must conform on a uniform basis to applicable laws and regulations and consumers must be protected not only from coercive activities but also from losses resulting from insolvencies. Achieving a level regulatory playing field on which the different types of financial institutions can compete equally has been widely supported by both public officials and by participants in the industries involved. It appears, however, that public utterances and private feelings are often at odds with each other. Each industry seems anxious to obtain its own advantage when its firms enter new financial service activities while at the same time maintaining its present advantages when firms from other industries seek to enter its preserve. All businesses must be subject to the same regulatory ground rules if they are to compete in the same areas.

The first question to be answered is: who will regulate an organization that does both a banking and an insurance business. Banks, as you well know, are presently regulated by a combination of state and federal regulators and insurers by state regulators. The question is: who will regulate the insurance function of a bank?

Will it be one of the federal bank regulators, the state bank regulator, or the state insurance regulator? Will it be a combination of all of the above? If the insurance function of a bank is subject to federal regulation, will other insurers be brought within the purview of such federal regulation? If the insurance function of a bank is regulated by a bank commissioner, be that federal or state, will such regulation be the same as regulation at the state level by an insurance commissioner? Parity of regulation between conventional insurers and those affiliated with banks is paramount.

Second, there must be consideration of the potential for unfair trade practices. Commercial banks, because of the special leverage associated with their lending power, are in the position to suggest to their credit customers that it is in the customer's best interest to use other services offered by the bank. Of even greater significance is the coercive atmosphere surrounding the credit transactions -- the perception many consumers and business people have that their chances to receive a loan or continue their line of credit will improve if they purchase insurance from the lender or the lender's affiliate. This type of subtle coercion, instead of creating competition, stifles it by eliminating product quality and price as considerations in the consumer's purchasing decision. Effective deterrents to such pressure must be found. Broadened entry of banks into insurance and other non-banking areas could easily exacerbate this leverage problem.

Third, there could be conflicts created by the existence of multiple insolvency fund systems. How will the FDIC and state insurance property and casualty insurance insolvency funds interrelate if banks enter the insurance business? Will reinsurance purchased to protect against certain risks be considered assets of the bank and thereby subject to claims by bank creditors? There must be a segregation of assets, liabilities and reserves, so that should an insolvency occur, one could be assured that the assets which back up certain portions of the business are in fact attributed to that portion.

Fourth is the question of accounting. Banks, generally, use GAAP accounting. Insurance companies use the more conservative accounting method prescribed by the National Association of Insurance Commissioners (NAIC) in the Annual Statement filed with all states. This method attempts to ensure that an insurer's assets are always sufficient to cover its liabilities. Using the NAIC Annual Statement method of accounting is essential for insurance purposes in order to protect consumers against insurance company insolvencies.

Will the conversion of banks and insurers produce a move towards GAAP accounting for insurers? Will banks' participation in the insurance business be so structured that the insurance portion of the bank will pay federal income taxes, premium taxes and other state fees and assessments as do insurers? In many states, for example, banks pay corporate income taxes while insurers pay premium taxes. Again, the banking and insurance entities must be separate so that the banking business can use GAAP and the insurance business can use statutory accounting. This may well require complete walling off of the assets of the bank from those of its insurance business.

To be specific, in order to achieve this important level playing field, we believe that the following criteria must be adopted:

- Regulatory Equality - All businesses must be subject to the same regulatory ground rules if they are to compete in the same areas. This requires that all insurance activities, whether of banks or of insurers, be regulated by state insurance departments under the state insurance code. If banks are allowed to write insurance, insurers should be allowed to enter the banking field.
- Unfair Trade Practices - Consumers must be protected from coercion and tie-in sales through strict prohibitions and regulatory oversight.
- Insolvency Protection - The functions and operations of the Federal Deposit Insurance Corporation, state property and casualty guaranty funds, the Securities Investor Protection Corporation, etc., will have to be protected and safeguards established to assure that assets which back specific portions of a business are not used in the event of an insolvency of another portion.
- Accounting Differences - Current distinctions between bank and insurance accounting practices are essential to the safety and soundness of both businesses.
- Inherent Advantages - Banks should be allowed to use only their surplus to fund their insurance activities so that low-cost depositors' funds, subsidized by federal deposit insurance, and funds obtained through the Federal Reserve discount window, are not used to subsidize other activities or bias competition.

- Corporate Structure - In order to insure that banks are regulated by bank regulators and insurers by insurance regulators, and for all of the other reasons above, if banks are allowed to underwrite insurance the Alliance greatly prefers that they do so only through separate corporations.

The reason we must oppose S.2181, in its present form, is that it fails to meet these criteria.

As we stated previously, if regulatory equality can be achieved the Alliance would not oppose permitting financial institutions to underwrite property and casualty insurance. Our companies believe in competition; we do not "select" our competitors. Competition generates innovation; it stimulates quality service; it controls price. S.2181 would not, unfortunately, achieve these results without major changes.

The problems which need to be overcome are serious. To a large degree, these difficulties reside in the fact that banks are unique. They are the primary source of liquidity for all other classes and sizes of institutions, both financial and nonfinancial. Banks provide loan commitments and letters of credit in addition to continuing lines of credit. Virtually all other financial markets and other classes of institutions are directly or indirectly dependent on the banking system as their standby sources of credit and liquidity. Banks can do this because they have access to deposits and to federal money. The ultimate question is -- if banks are to be permitted to underwrite insurance -- can there be equality of regulation in light of the unique, inherent advantages which they enjoy?

S.2181 Fails to Provide A Level Playing Field

- Regulatory Equality

We strongly believe that only the states should regulate insurers' activities and powers. However, under S.2181, every bank holding company that wants to get into the insurance business without turning all of its banks into consumer banks will have to submit to some regulation of its insurance activities by the Federal Reserve Board. These activities must be approved by the Board (if they are begun de novo); the Board may regulate both the holding company and the insurer on a continuing basis, including examinations, and the Board can order the holding company or the insurer to limit or cease insurance operations. The same is true for a thrift holding company (even if it only owns one savings and loan) that wants to start selling and writing insurance without turning its savings and loan into qualified thrift lenders, although the federal regulator is different. Current insurers could be subject to the same federal regulation as well, if they own a savings and loan that is not a qualified thrift lender or a non-bank bank that is not a consumer bank (at the least, such insurers would be subject to the grandfathering restrictions mentioned above).

Insurers that somehow become part of a bank-or-thrift holding company will also not have the full freedom to use their states' investment laws, but will be restricted by either the federal bank or thrift holding company laws.

S.2181 further concerns us since it could give rise to conflicting state and federal regulation. This could arise in at least two ways:

1. The NAIC Model Insurance Holding Company Act gives the

state insurance departments, in states that have enacted the Act the power to regulate insurance holding companies, defined as companies that control one or more insurers. A bank holding company that owns an insurer would also be, therefore, an insurance holding company. Thus, it would be regulated by the Federal Reserve Board under the Bank Holding Company Act and the state insurance departments under the NAIC Model Insurance Holding Company Act. The two acts are different, and the NAIC act is generally stricter. The fact that both the NAIC and the Federal Reserve Board would have jurisdiction raises the prospect of conflict between federal and state regulators, neither of which would likely be willing to surrender primary (or exclusive) responsibility for holding company regulations.

2. The federal Bank Holding Company Act regulates coercive sales involving the use of credit leverage by banks. S.2181 would strengthen these protections. Section 5 of the NAIC Model Insurance Holding Company Act contains similar protections, enforceable by state insurance departments. Unfortunately, since bank holding companies selling insurance will probably also be insurance holding companies, both the Board and the state insurance regulators will want to enforce their laws. This could lead to further regulatory conflict, and possibly to further federal encroachment on state insurance regulation.

We would urge that S.2181 be amended to provide that bank holding companies be restricted from selling or underwriting insurance directly.

Since mutual insurers cannot establish upstream holding companies, they should be allowed to establish downstream holding companies that can underwrite insurance, with the downstream holding company, rather than the mutual insurer, defined to be a bank holding company. The only involvement of a federal regulator of the insurance subsidiary of a bank or thrift holding company should be to authorize an insurance subsidiary to apply with the state insurance regulators for insurance licensing in those states which it wishes to do business. Once the Board had granted the subsidiary authority to apply for an insurance license, the insurance entity would then be viewed as any other corporation wishing to enter the insurance business, and would not be subject to federal regulation, except that the Board could require the holding company to divest itself of a subsidiary insurer if it determined that the safety and soundness of an affiliated bank was threatened. In the case of a mutual insurer, for the same reasons the Board could require the subsidiary holding company to divest itself of the bank. The Board would have no other authority over the mutual insurer. State statutory requirements as to capital and surplus would apply. The subsidiary insurer would be expected to meet all state laws and regulations. Its accounting procedures would have to comply with state insurance accounting practices. Its investment opportunities would be regulated by the laws applicable to the state which it had been licensed to do business. In other words, the insurance entity would be treated as any other insurer, whether or not related to banks. These provisions would allow the states, which have the experience in this area, to continue to regulate insurers, while allowing the Board to continue to regulate bank holding companies.

Our position is that State control over all insurance activities must recognize that insurance companies would continue to be regulated at the state level; not be subject to regulation by the Federal Reserve Board; and that insurers would not be prohibited by the Bank Holding Company Act from engaging in activities permitted under state insurance laws.

- Unfair Trade Practices

Section 107 of S.2181 borrows extensively from the National Association of Insurance Commissioners (NAIC) Model Insurance Unfair Trade Practices Act. We believe that this is one approach to control the serious potential for coercive activities. However, this section would not apply to savings and loans, which are prohibited only from direct tie-in by 12 U.S.C. 1464(g).

The bill also contains a subsection imposing a 30-day "cooling off" period during which a bank would have to accept the cancellations of a credit-related policy by a borrower of the bank, and would have to repay the unearned premium within 20 days from the date of notice. S.2181 would also give a trade association the right to enforce this section by seeking injunction relief.

Section 109(b) of S.2181 would extend the trade association's right of action to tie-ins by thrift institutions. The Alliance proposes that anti-tie-in and anti-coercion provisions be extended to cover all thrifts as well as banking institutions.

The Alliance also recognizes that further strengthening of federal anti-tie-in and coercion laws is necessary in order to fully dispel the coercive atmosphere surrounding insurance transactions with lenders. The Alliance is reviewing this subject and will be suggesting additional amendments.

- Insolvency Protection

The corporate structure of an integrated financial service institution needs to insure that assets meant for the protection of one set of customers may not be transferred to others. Otherwise, insolvency of an integrated financial services institution would require the inner-action of the insurance guaranty funds with the insolvency protection mechanisms of other financial industries. Such necessary inner-action would lead to a reduction in consumer protection.

Unless assets are prohibited from being transferred from one institution to another, insolvency of an integrated financial services institution, with insurance, banking and securities businesses, would trigger participation of all the various protection funds. This would create impossible situations. For example:

- Will the combined capabilities of all these mechanisms be strong enough and flexible enough to contain the insolvency of a large, integrated and complexed financial services system?
- If one part of a financial conglomerate becomes insolvent, how would the liabilities be coordinated and allocated among the various mechanisms? For example, if a federally-insured bank that underwrites insurance becomes insolvent who insures

that policyholders and depositors are protected? The FDIC, insurance guaranty funds and state insurance and bank regulators will all have an interest in how the insolvency will be handled and their roles are likely to be massively confused in a regulatory turf fight. It would be very difficult to determine which liabilities the FDIC and the insurance guaranty funds assume.

The bankruptcy of a financial services institution would surely bring to the surface conflicting priorities and procedures among the insolvency protection groups inevitably adding to the time and cost involved in paying consumer claims. It would also result in the various insolvency protection mechanisms vying for a large share of the limited assets of the company. In the event the guaranty funds do not receive an appropriate share, the consumers would pay substantially greater amounts for insurance coverage.

The success of businesses providing financial and insurance services depends upon continued public confidence. This trust results in part from the protections afforded the consumer through the various insolvency fund mechanisms. Confusion, excessive costs or failure of these mechanisms due to the bankruptcy of an integrated financial institution could be ruinous for all related businesses. It is most important that there would be not commingling of funds between the bank insurance entity and the bank. In the event of an insolvency, it is very important that the consumer be protected.

- Accounting Differences

S.2181 does not speak to the two different accounting procedures used by the banking and insurance industries. The banks use the GAAP system of accounting and the insurers use statutory accounting as prescribed by the NAIC -- the National Association of Insurance Commissioners.

Since we are urging that all insurance activities be regulated by the states it goes without saying that accounting procedures prescribed by state insurance commissioners should control all insurance entities.

Insurance underwriting is a unique business; the true cost of insurance is not known until after the sale has been consummated (after the loss has occurred). Therefore, it is necessary that this fact be taken into account, as is being done today through the statutory accounting method, which state insurance regulators have developed.

Failure to require uniform accounting procedures for all insurers, whether subsidiaries of banks or conventional insurers could create serious anomalies. For instance, since as noted above statutory accounting is more conservative, an insurer could well be found to be insolvent if audited under the state prescribed statutory accounting method but could still appear solvent under GAAP accounting. This would fetter the ability of state regulators to control the assets of weak insurers.

Thus, it would be necessary for the protection of policyholders to require that the insurance entity of banks use whatever accounting system is prescribed by state insurance regulators.

- Inherent Advantages

Banks are in the money business and have the privilege of borrowing funds at a discount from the lender of last resort -- the Federal Reserve Bank. S.2181 should make it very clear that a bank cannot use money which it borrows from the Federal Reserve discount window to enter the business of insurance. A bank should only be able to use its surplus funds in order to enter and develop its insurance activities.

We will be providing the Committee with amendments to S.2181 to insure that banks would not, directly or indirectly, be in a position to use money borrowed from the discount window of the Federal Reserve to establish an insurance company. As stated previously, the bank should be able to use only surplus funds with which to establish an insurer.

- Corporate Structure

S.2181 provides for the insurance subsidiary of a bank to be set up within a separate corporation. We believe that this is an important element which would facilitate integration and remove a number of concerns which we have addressed above.

CONCLUSION

Mr. Chairman, as we have already stated, we must oppose S.2181 since it fails to meet the criteria which the Alliance has developed to insure that integration of financial services will insure a truly competitive marketplace. We are prepared to continue to work with you, committee members and staff on S.2181.

If all the aforementioned criteria are met, the Alliance would then withdraw its opposition to the section of the bill authorizing banks to underwrite insurance. However, we would not take a position of affirmative support.

Mr. Chairman, we again thank you for the opportunity to present our views concerning the entry of banks into the insurance business. We will be happy to respond to questions.

The **Chairman**. Thank you, Mr. Jones.

Mr. Kennedy.

STATEMENT OF DONALD P. KENNEDY, PRESIDENT, AMERICAN LAND TITLE ASSOCIATION; PRESIDENT, FIRST AMERICAN TITLE INSURANCE CO., SANTA ANA, CALIF.

Mr. **Kennedy**. Mr. Chairman, my name is Donald P. Kennedy and I am appearing today in my capacity as president of the American Land Title Assocation which has approximately 2,000 members and is represented in every county in the United States. It's a relatively small segment of the insurance industry but we feel an important segment.

We have a more detailed statement which I request be included in the hearing record.

The **Chairman**. All of your statements will be included in full in the hearing record.

Mr. **Kennedy**. Thank you.

[Complete statement follows:]

Written Statement of the American Land Title Association Before the Senate Committee on Banking, Housing and Urban Affairs

March 6, 1984

Presented by:

Donald P. Kennedy,
President

The American Land Title Association (ALTA) is pleased to submit its views on S. 2134 and S. 2181 to the Senate Committee on Banking, Housing and Urban Affairs, and to participate in the public debate on the legislative framework that needs to be established to ensure the continued safety and soundness of our nation's financial institutions. ALTA is the national trade association of the land title industry, and has approximately 2,000 members, including title insurance underwriters, title insurance agents, abstracters, and associate members, whose principal function is to insure the safe and efficient transfer of and investment in residential and commercial real estate.

Problems affecting our nation's financial institutions are of vital concern to the members of ALTA. Unlike most other types of insurance, title insurance is only purchased in connection with a real estate transaction. Because the volume of real estate transactions is dependent on the availability of mortgage money and on the continued health of the financial institutions that play a preeminent role in providing such funds, problems that jeopardize the safety and soundness of these institutions will inevitably jeopardize the health of the title insurance industry.

For these reasons, ALTA is sympathetic to the need for federal legislative action that would address the problems currently facing these institutions and to the need for Congress to consider the possible expansion of their range of permitted activities so as to enable these institutions to respond to the changing market conditions of the 1980's. But in considering the legislative changes that are needed, ALTA believes it is imperative that Congress not ignore the problems and risks that may be inherent in allowing these institutions to engage in certain activities -- particularly if those activities may jeopardize their continued ability to meet the present and future mortgage needs of our society. As Senator Proxmire indicated in introducing S. 2134,[1] the basic policy issue facing the Congress is finding the proper balance between these competing considerations for each particular activity. Some new activities may not raise significant conflict of interest or other problems that create risks for the safety and soundness of our financial institutions, or may not pose significant competitive or consumer problems. Other activities, in contrast, may raise such significant risks and problems in these regards that Congress should not authorize them.

While ALTA supports the views that have been expressed by representatives of other segments of the insurance industry on the need for the continued separation of banking and insurance, this statement will not repeat the concerns and problems that have been expressed by these other insurance groups. Rather, it will address certain problems that the Committee and the Congress

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1/ 129 Cong. Rec. S.16954-56 (daily ed. Nov. 18, 1983).

may not have focused on to date and that are of vital concern to our industry: namely, the risks and problems that will be created if affiliates of mortgage lending institutions are permitted to enter the insurance business and to insure the mortgage loans of their affiliated institutions. These risks, particularly in the case of title insurance, should be of deep concern to this Committee since they are risks that (i) directly threaten the safety and soundness of mortgage lending institutions, (ii) undermine the objectivity and integrity of the title insurance underwriting process, and thereby threaten the continued healthy functioning of the secondary mortgage market, (iii) jeopardize competition in, and the stability and soundness of, the existing title insurance industry, and (iv) are likely to impact adversely on mortgage borrowers.

For the reasons that have been articulated by other insurance industry representatives, ALTA supports legislation that would continue to maintain the separation of the banking and insurance industries as currently provided in the Bank Holding Company Act; indeed, ALTA believes that similar restrictions should be applied to other federally-regulated financial institutions as well. But no matter what the scope of insurance activities Congress ultimately decides is permissible for banks and other financial institutions, it is absolutely imperative, as will be evident from the balance of this statement, that Congress restrict such authority so as to prohibit those institutions or their affiliates from issuing title insurance policies on their own mortgage loans.

In order to provide the Committee with a complete understanding of ALTA's concerns and position, this statement has been divided into two parts. The first part provides some background information on title insurance that is a necessary predicate for the discussion in the second part on the risks and problems that will be created if lenders engage in title insurance activities with respect to their own mortgage loans.

I. Background Information on Title Insurance

A. The function of title insurance: protection of the mortgage lender and the purchaser of real property.

Unlike most other types of insurance that insure against unknown or unknowable future events, such as deaths or accidents, title insurance protects against unknown or unknowable past events or matters that may give rise to claims that will jeopardize the insured property owner's use, enjoyment or alienability of the property or may jeopardize the security of the mortgage lender's lien on that property.

Because the lender's and owner's interests in the insured property are not coincident, the nature of the title insurance protection provided to each is somewhat different. For a mortgage lender, the lien it obtains on the mortgaged property serves as the basic security for its mortgage loan. Accordingly, a lender's title insurance policy is intended primarily to provide the lender with the assurance that its mortage lien will be valid, that it will have the proper priority over other liens and encumbrances on the property, and that it will be enforceable. On the other hand, the title insurance policy issued to the purchaser who is acquiring the property is intended to insure the risks he is primarily concerned about -- risks that relate to the peaceful use and enjoyment of the property free of unknown liens, claims, or encumbrances. Because of the different interests of the lender and the owner in the property, there may be a number of matters or encumbrances affecting the title that are only of marginal interest to the lender, but which are of significant interest to the purchaser. For example, the existence of an easement that does not materially affect the mortgage lender's lien will be of little concern to the lender, but may greatly affect the owner's use and enjoyment of the property.

B. The underwriting of a title insurance policy.

Because title insurance involves the assumption of risks arising from matters or events that may have occurred prior to the date the policy is issued and that affect the particular property to be insured, before the policy can be issued an individualized underwriting examination of the title to that particular property must be made. This examination is needed to determine the state of the title, to identify the validity and potential impact of any liens, claims, and encumbrances that may exist with respect to that property, and to enable the insurer to assess what risks affecting the title may be prudently insured. Such underwriting cannot be performed on the basis of actuarial or statistical predictions, since, with respect to any particular property, there is no way to predict on an actuarial or statistical basis whether the lender will have a valid and enforceable lien or whether there is, in fact, any lien, claim or encumbrance on that property that has been recorded in the official public records.

This individualized underwriting evaluation for each parcel of property not only protects the title insurer by identifying existing liens, claims, and encumbrances that must be excepted from the policy's coverage, but also benefits the insured owner of the property and the insured mortgage lender by providing assurances that the title insurer's comprehensive and independent evaluation of the title has found no unreasonable threat to the owner's title or to the lender's lien. The knowledge that an independent identification and evaluation of the title-related risks has been performed is an important part of the security furnished by a title insurance policy. Indeed, in many ways the knowledge that there has been an independent identification and evaluation of the title-related risks may be as valuable as the guarantee of financial indemnification that is provided by the policy.

In general, this individualized underwriting examination of the title cannot be performed at the home office of the underwriter, since it requires both access to the local land records (usually maintained at the county level) in which matters affecting real estate titles are recorded and an intimate knowledge of the many laws in the particular local jurisdiction that bear upon rights in real property. Where the volume of real estate transactions in the locale warrants it, the underwriter may maintain a so-called "direct" operation, whereby it performs these underwriting functions through a branch office. In a great many areas, however, the underwriter is not able to maintain a direct operation and must therefore utilize the services of a local title insurance agent who assumes responsibility (subject to guidelines developed by the underwriter) for these underwriting functions.

In general terms, there are four essential functions that must be performed in connection with the underwriting and issuance of a title insurance policy -- functions that are typically performed by a full service title insurance agent on behalf of the underwriter in areas where the underwriter does not maintain a direct operation. First, the agent must ascertain which documents, liens, claims, and encumbrances are relevant to or affect the title to the property that is to be insured. This function may be performed from the public records, from an abstract of title, or from a title plant that the agent may own. Second, the agent must examine these materials and make an assessment of their impact on the state of the title. Third, the agent must make certain decisions regarding whether title has been vested properly, which liens, claims, and encumbrances must be noted as exceptions to the policy's coverage, and the scope of the insurance coverage that can be provided (e.g., eliminating standard exceptions or affording affirmative coverage for specific matters). Fourth, the agent must prepare and issue the policy itself and collect the appropriate premium. (In addition, in many areas of the country, the agent may also handle the mechanics involved in the settlement or closing.)

As is evident, the underwriting functions and responsibilities involved in the issuance of a title insurance policy differ significantly from the more generic or statistically-based underwriting engaged in by other types of insurers. Moreover, the functions of a title insurance agent differ significantly from the essentially sales-related functions of agents in most other lines of insurance. Of particular importance, in underwriting a policy insuring the lender's mortgage lien, the title insurer (or its agent) must make certain judgments regarding documents drafted or utilized by the lender -- such as determining whether and the extent to which the loan documents will create a valid, enforceable first mortgage lien for all amounts due the lender under that loan.[2] In the case of other types of insurance that may protect the lender's interest (such as fire insurance), the underwriting judgments that have to be made rarely, if ever, require this type of independent assessment of the effect of documents used by the lender in the instant transaction.

Because of these differences and, as will be explained in Part II, below, the risks and problems that inevitably will be

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2/ These underwriting judgments have become particularly important in recent years in light of (i) the wide variety of variable-rate mortgage loans that have come into use to replace the traditional fixed-interest mortgage loan and (ii) the legal uncertainties regarding the precise extent to which the basic lien created by the mortgage will secure the periodically-changing amounts of interest or principal due on such loans.

created if mortgage lending institutions are permitted to engage in title insurance activities (whether as underwriters or as agents) in connection with their own mortgage loans are far more serious than those created by the entry of such financial institutions into other types of activities.

C. The consumer demand for title insurance: the voluntary tie-in problem.

Unlike most other services that lenders may wish to offer to consumers, title insurance is required by a consumer only as an incident to a real estate-related transaction -- usually the purchase of a home. Because most consumers purchase a home infrequently, and because in the period between the signing of the purchase contract and the time a decision must be made on the selection of a title company[3] they are far more concerned about such matters as obtaining mortgage financing, arranging to sell their existing homes, preparing to move, etc., they are not in a good position to acquire the knowledge or expertise to be able to judge for themselves which title company may provide the best combination of service, policy coverage, and price. Moreover, given the relatively modest amount of the one-time premium that is paid for title insurance in comparison with the substantial other costs that will be incurred in the real estate transaction,

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3/ The phrase "title company" is used throughout this statement to refer both to title insurance underwriters and title insurance agencies.

most consumers have little incentive to expend much time or effort in shopping for title insurance.

Accordingly, the vast majority of consumers look to and rely upon the knowledge and expertise of a real estate professional in the transaction to recommend or suggest a particular title company. Frequently, this recommendation will come from the mortgage lender. The fact that most consumers do not have the time, ability, or incentive to make the selection of a title company on their own makes it highly likely that a recommendation by the lender will be accepted by the borrower.

The probability that the borrower will accept the lender's recommendation is enhanced immeasurably by the fact that at the time the borrower must make a decision on the selection of a title company he is seeking a mortgage loan from -- or is negotiating the terms of that loan with -- the lender. In this context, even if the lender exerts no overt pressure on the borrower to purchase title insurance from an affiliated company, the borrower is likely to perceive that the prospect of obtaining the loan he wants can be enhanced by giving the title insurance order to the lender's affiliate. The net effect, which has been referred to as a "voluntary tie-in," is that, under these circumstances, the consumer's choice of a title company is effectively controlled and directed by the mortgage lender. The overall impact on the consumer is the same as if an explicit tie-in existed.

This voluntary or implicit tie-in problem is not as severe with regard to other types of financial services that a lender may offer where the consumer has the time, knowledge, or incentive to make an informed decision on whether to purchase such services from the lender or from another source, or where the consumer's decision is not made as close in time to the lender's decision to grant or withhold mortgage credit.

Also, most of the other types of products or services that a lender (or its affiliate) might seek to sell to the consumer are either sold for a limited, renewable term (such as life, property or casualty insurance), or are purchased with some degree of frequency (such as securities brokerage services). In these instances, even if there is a tendency for a tie-in at the time the consumer first purchases the tied product or service, the consumer will always have an opportunity to shop for a better product or service at a later time. In contrast, title insurance is sold for a one-time premium, rather than on a periodically renewable basis, and protects the owner for as long as he has an interest in the property. Accordingly, there is no renewal market for title insurance. Since most of the revenue received by a title company in a transaction is devoted to the costs involved in the underwriting functions discussed above -- all of which are performed before the policy is issued -- the purchaser of a title insurance policy cannot cancel the policy after it is issued, obtain a refund of the premium, and then change insurers. The net result of these differences is that the adverse impact of the implicit tie-in that may exist with regard to title insurance will be considerably more severe than for other products or services offered by lenders.

ALTA recognizes that several provisions of S. 2181 are intended to eliminate or reduce the tie-in problems that may exist with respect to insurance sales by lending institutions. Whatever impact these provisions may have on limiting the adverse effects of tying with regard to other types of insurance, it is clear that such provisions cannot remedy the problem of implicit tying of title insurance by a mortgage lender. First, section 107(2) requires a lender to give the consumer a written disclosure of the consumer's right to select an insurance company or agent of his own choice. Whatever benefit such a disclosure might provide with regard to insurance products that consumers have some familiarity with and are in a position to shop effectively for, this disclosure will have little impact with respect to title insurance sales. As discussed above, there are functional reasons why consumers lack the time, knowledge or incentive to shop for title insurance, and simply telling the consumer that he has the right to select his own title company will not overcome these disabilities.

Second, while it may appear that the provisions of section 107(2) -- which prohibit a lender from soliciting the consumer's insurance business until after a written loan commitment has been given -- will reduce the pressure on the consumer to follow the lender's recommendation of its title company affiliate, this will not be the case. Given the fact that many borrowers of mortgage loans may envision the need to maintain a good relationship with the lender even after the loan commitment is given or the loan is actually made (because the borrower may need the lender's goodwill in the event he wishes to refinance or prepay the loan), most consumers will conclude that their interests would best be served by accepting the lender's recommendation rather than risk offending the lender by saying that they would prefer not to use its title company.

Third, the cooling-off provision of section 107(2) is simply not applicable in the title insurance context. Section 107(2) requires a bank to "accept . . . the cancellation by a borrower of any . . . insurance" issued by the bank or its affiliate in connection with a loan made by the bank if the cancellation request is made "within 30 days of the effective date of the insurance." The bank must then "refund [to the borrower] the unearned portion of the premium . . . if no liability for a loss under the insurance has been incurred." As discussed above, the bulk of the one-time premium for a title insurance policy is used to cover the costs of the underwriting functions, which are performed prior to the issuance of the policy. Consequently, after a title insurance policy has been issued, there remains relatively little "unearned" premium that can be refunded. Thus, the use of the cooling-off provision in the title insurance context would simply force a consumer to pay twice for his title insurance protection.

Finally, the existing anti-tying provisions of the banking laws, 12 U.S.C. § 1972, and the expansion of those provisions in section 107(3) to provide a right of action for injured competitors of the bank (through the competitor's trade association) will also be ineffective in the title insurance context. Those anti-tying provisions are addressed to the problem of explicit tie-ins (i.e., where the lender actually conditions the granting of a loan on the borrower's purchasing another service or product from the lender or its affiliates) and fail to address the real-world problem that in most instances a mortgage lender is able to steer the borrower to its affiliate without having to say "I won't give you the loan unless you use our title company."

* * *

The foregoing background will enable the members of the Committee to understand and appreciate ALTA's concerns about the significant risks and problems that exist when lenders are permitted to establish title insurance affiliates to write insurance on their own mortgage loans. The remainder of this statement describes those risks and problems that should be of particular concern to the Committee.

II. The Significant Risks That May Result If Mortgage Lending Institutions Are Permitted to Engage in Title Insurance Underwriting or Agency Activities.

A. Risks to the safety and soundness of these institutions.

While many similar risks and problems would be created for the continued safety and soundness of mortgage lending institutions whether they act as title insurance underwriters or agents, separate discussion of the two types of activities may be helpful to the Committee's analysis of these issues.

1. Risks that will arise if lenders engage in the title insurance business as underwriters.

One of the most significant problems that should be of concern to Congress in allowing mortgage lending institutions to underwrite the title insurance policies on their own mortgage loans is that such activities threaten the traditional independence and integrity of the title insurance underwriting process -- thereby jeopardizing the real protection that title insurance is intended to provide to mortgage lenders and directly affecting the continued safety and soundness of such institutions.

The basic safety and soundness objectives sought by mortgage lenders in obtaining title insurance on their mortgage loans are (1) to insure, on the basis of an independent, expert underwriting determination, the priority, validity, and enforceability of their mortgage liens, and (2) to eliminate the financial risks associated with title-related claims that may jeopardize those liens. When the title insurance underwriter is owned by or affiliated with the mortgage lender that is the originator of the insured loan, these two objectives will not be achieved.

a. Risks to the integrity of the title insurance underwriting process.

The issuance of a title insurance policy requires substantial expertise and requires an underwriter to exercise significant judgment in evaluating whether the lender's lien will be valid, enforceable, and afforded the required priority. As part of this evaluation the underwriter must determine the risks that may be insured against and those that cannot be insured against prudently. When a lender is dealing with an independent underwriter, the lender can be certain that the underwriter will issue a policy only on the basis of what the underwriter, in the exercise of its independent judgment, considers to be sound underwriting risk. While the interests of the lender in obtaining the broadest possible insurance coverage will be taken into account by the independent underwriter in deciding on the risks it can insure, any differences between the insurer and the lender regarding coverage will be the subject of arm's-length negotiation that is likely to result in underwriting decisions that reflect a sound and reasonable compromise between the interests of the insured (the lender) and the interests of the underwriter.

When the title insurance underwriter is owned by or affiliated with the lender, however, the integrity and independence of the underwriting process is clearly jeopardized. For example, if potential title problems are discovered that independent underwriters might not prudently insure, the underwriter affiliated with the lender may be more likely to make a judgment in favor of insuring that risk, particularly if the loan transaction would be jeopardized by the failure to provide such coverage. While it is impossible to predict the precise ramifications of the conflicts of interest that would be created in the underwriting process if lenders were affiliated with title insurance companies that issued policies on their own loans, experience -- particularly in the banking industry -- has demonstrated that arrangements that result in conflicts of interest should be avoided even if the precise extent of the problems created cannot be readily quantified in advance.

b. Risks to the financial security provided by title insurance to mortgage lending institutions.

To the extent that one of the primary objectives sought by a lender in obtaining title insurance on its mortgage loans is to transfer the financial risks of title-related problems and losses to a third-party, there is a serious question as to whether the placement of such insurance with a title insurance underwriter owned by or affiliated with the lender accomplishes that goal. Insurance is, by definition, the transfer of the economic consequences of risk from one party to another. When a lender uses its own title insurance affiliate or subsidiary to insure its loans, it is not transferring the economic consequences of the risks of those loans to another entity -- it is merely self-insuring those risks, albeit through the mechanism of a related corporate entity. Economic literature has recognized that in this "affiliated insurance" context, the risk of loss may appear to be transferred as a formal matter, but the burden of loss still rests ultimately on the insured, making captive insurance "the epitome of the self-insurance device."[4]

Thus, when a lender insures its own mortgage loans with an affiliated title insurance underwriter, it is not actually obtaining the financial security that title insurance is designed to provide because it is not transferring the economic consequences of the risks out of its corporate family. Even if the captive underwriter does a portion of its business by insuring loans of third parties as well, the captive underwriter still retains the risk associated with the lender's loans and thus the lender remains a self-insurer to such extent. In view of the widespread recognition that the use of title insurance has enhanced the safety and soundness of financial institutions by reducing the financial risks associated with their mortgage lending activities, ALTA believes that the Committee must be concerned about whether the use of such a captive insurance mechanism really serves the safety and soundness goals that are achieved when the financial risks to be insured are placed with an unaffiliated third-party insurer.

The use of captive underwriters also threatens the financial security that title insurance is designed to provide in another

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4/ R. Goshay, "Captive Insurance Companies," in H. Snider, Risk Management 80, 85 (1964).

way. When dealing with independent underwriters, lenders continually review the quality of those underwriters' services and their financial strength and soundness so as to be alert to changes in their balance sheets or general financial conditions that might adversely affect the ability of the underwriters to respond to claims made on the policies they issue. But when a lender owns or is affiliated with an underwriter, the incentive to continue to send business to that affiliate could easily cloud what would otherwise be an independent judgment by the lender regarding the safety and soundness of continuing to have its mortgage loans insured by that underwriter. Moreover, the fact that the affiliated underwriter may be facing financial difficulties may serve only to strengthen the lender's incentive to refer business to it, in the hope that by placing even more business with that underwriter it can help to solve the underwriter's financial difficulties. If the lender has all or most of its mortgage loans insured with its captive underwriter, the insolvency or failure of that underwriter would have enormous adverse consequences on the safety and security of the lender's mortgage loan portfolio. This is in contrast to the current situation whereunder the mortgage loans of a lender may be insured by a number of different underwriters and where the insolvency of any one underwriter may affect only a small portion of the lender's loan portfolio. In short, the desire of a lender to maximize the profitability of its captive title insurer (or to remedy its financial problems) by directing as much of its insurance business as possible to that captive underwriter could easily override the concerns that the lender should have regarding the safety and soundness of its mortgage loan portfolio.

2. Risks that may arise if mortgage lending institutions act as title insurance agents on their own mortgage loans.

The previous section focused on the risks inherent in mortgage lending institutions being affiliated with title insurance underwriters that will insure their own loans. But equally significant conflicts and problems exist if mortgage lenders own or are affiliated with title insurance agencies to which they refer the title insurance business arising out of their own mortgage loan transactions.

There is an inescapable conflict of interest when the agent that will issue a title insurance policy on behalf of an underwriter is owned by or is affiliated with the lender that will be insured under that policy. In any insurance transaction, there is an obvious conflict between the interests of the insured in obtaining the broadest policy protection and the interests of the underwriter in assuming only prudent and reasonable risks. This problem is particularly acute in the case of title insurance, because the coverage of each title insurance policy is unique and is a function of the many liens, claims, and encumbrances that may affect the title of the particular parcel of property that is insured.

Given the extensive discretion the title insurance agent has to determine the scope of the liability that the underwriter will be committed to under policies it issues on the underwriter's behalf, the conflicts of interest that are present when the title insurance agent is owned by or affiliated with the prospective insured (i.e., the lender) become obvious. In its desire to protect the interests of its affiliated lender or to ensure the ready acceptance of the lender's mortgage loans in the secondary market, a lender-owned title insurance agent might easily insure over certain problems in the belief that such actions will not result in title claims against the underwriter or that, in any event, any losses suffered will be a problem for the underwriter rather than for its affiliated lender. The result will be an overall deterioration in title insurance underwriting standards and less assurance that the policy represents a true evaluation of the security provided by that parcel of real estate.

In normal circumstances, a title insurer would not continue its agency relationship with an agent that failed to maintain prudent and professional underwriting standards. But where the title insurance agent is owned by one or more lenders that have a strong financial interest in continuing to send business to that agency, the underwriter may conclude that, unless it is willing to forego access to that portion of the market that is represented by those lenders' mortgage transactions, it should continue to underwrite the affiliated agent in circumstances where it would not ordinarily do so.

In short, whereas title insurers that underwrite independent title insurance agents have a natural self-interest (one that coincides with the interests of all insureds) in enforcing high standards regarding the competency and underwriting judgments of those agents, when the insurer knows that the agent is owned by a lender that effectively controls the placement of a significant volume of title insurance business, it may be much less willing to enforce those standards against that agent. The consequent decline in the integrity of the title insurance underwriting process will not only affect the title insurance underwriters who stand behind such policies, but all insureds -- including mortgage lenders and purchasers of mortgage loans in the secondary market -- who are protected by such policies.

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The desirability of prohibiting lending institutions from engaging in title insurance activities has been recognized for almost fifty years by the federal agency most concerned with the financial safety and soundness of banks, the Federal Deposit Insurance Corporation (FDIC). The FDIC has followed a regulatory policy since 1935 that has expressly prohibited state nonmember insured banks from engaging in title insurance activities. This policy is now codified at 12 CFR Part 332 (entitled "Powers Inconsistent with Purposes of Federal Deposit Insurance Law") and prohibits state nonmember insured banks from "insuring, guaranteeing or certifying titles to real estate." The reasons for the adoption of this regulation were explained in the following terms in a 1946 internal FDIC memorandum:[5]

5/ A copy of the 1946 memorandum is attached to these comments.

> The Board has consistently held that the powers listed above [insuring, guaranteeing or certifying titles to real estate] are inconsistent with the purpose of our Act. Banks which have been admitted to insurance since the Banking Act of 1935 have been required either to amend their charter so as to eliminate such powers or have been required to agree that they would not exercise such powers so long as they were insured banks. The Board having imposed such condition on banks admitted subsequent to the passage of the Banking Act of 1935, in the opinion of the committee, should prohibit other insured banks which are not now exercising such powers from so doing.

ALTA believes that the FDIC's long-standing conclusion that allowing banks to engage in title insurance activities is inconsistent with the purposes of the federal deposit insurance law continues to represent sound public policy.

B. Risks to the healthy functioning of the secondary mortgage market.

As the Committee is no doubt aware, the secondary mortgage market has come to play an increasingly critical role in assuring the continued availability of mortgage money to home buyers and other purchasers of real estate throughout the United States. In years past the secondary market has served the essential function of facilitating the flow of mortgage funds from one part of the country to another. Recently, however, it has served the added function of enabling mortgage lenders to reduce their financial exposure in carrying long-term mortgage loan investments. As interest rates have become increasingly more volatile, mortgage lenders have turned to the secondary market as a means of avoiding the financial risks associated with a large portfolio of loans whose interest rates may be lower than the lenders' cost of funds or the current interest rates. By selling their loans in the secondary market, mortgage lenders are then able to "recycle" their funds into new loans at current market rates. The increase in the percentage of mortgage loans sold in the secondary market since 1979 has been nothing short of phenomenal.[6]

The growth of the secondary market and the continued willingness of purchasers in that market to invest in mortgage loans are inextricably linked to the assurances regarding the safety and soundness of such investments that have been provided by the existing, independent title insurance industry. The members of the ALTA are justifiably proud of the role that sound, creative, and independent title insurance underwriting has played in facilitating the nationwide acceptability of a wide variety of mortgage instruments as safe and prudent investments by individuals and institutions. ALTA believes, however, that the conflicts of interest that will arise if mortgage lenders obtain effective control of the title insurance underwriting process could have an enormous adverse impact on the secondary market, with a consequent adverse impact on all financial institutions that originate mortgage loans. Ultimately, this impact will have

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6/ For example, in 1979 approximately $98 billion in mortgage loans were made by thrift institutions insured by the FSLIC, while $18 billion in loans and participations were sold by such institutions in the secondary market. In 1982, however, such institutions made $53.36 billion in mortgage loans, and sold $53.43 billion of mortgage loans and participations in the secondary market. 16 Federal Home Loan Bank Board Journal 44 (November 1983).

an adverse effect on the housing market itself -- which is so greatly dependent on the recycling and transfer of funds made possible by the secondary market.

Purchasers of loans in the secondary mortgage market universally require title insurance because the ultimate security they have for their investments is the validity, priority and enforceability of the liens on the underlying mortgaged properties. They demand title insurance protection not only because a title insurance policy provides financial indemnification in the event of title-related losses, but because of their knowledge that before the policy is issued a thorough and independent examination of the title has been made, title problems that may affect the mortgage lien have been identified or, where appropriate, eliminated, and an independent, professional judgment has been made that the mortgage instrument has been drafted, executed, and recorded in a manner that will protect the validity and enforceability of the lien.

The confidence that purchasers of mortgage loans have developed in the security of their mortgage liens as a result of the independent underwriting of the existing title insurance industry would be gravely affected by the conflicts of interest created if mortgage lending institutions obtain effective control of the title insurance underwriting process. Even if the mortgage lending institutions do not attempt to influence the underwriting judgments of their affiliated title companies, purchasers in the secondary market may have a well-founded perception that such judgments (particularly judgments regarding the exceptions to the policy's coverage that may have to be taken as a result of the examination of the title) have been affected by the affiliated companies' natural desire to enhance the marketability of the mortgage loans that their affiliated lenders will be endeavoring to sell in the secondary market.

Precisely how these conflicts of interest will affect the willingness of investors in the secondary market to continue to purchase loans cannot be foreseen with certainty. That they will have a long-term adverse impact seems clear. Given the importance of the secondary market to all mortgage lending institutions and the interdependence between the secondary market and the housing market, the Committee should be concerned about enacting legislation that would permit and indeed encourage these conflicts of interest.

C. Risks to competition in the existing title insurance industry.

In light of the billions of dollars in mortgage loans held by banks, by other lending institutions, and by investors in the secondary mortgage market that are insured by the existing title insurance industry, there can be little question that all lenders -- as well as the public -- have a vital stake in the continued soundness and stability of the title insurance industry. Accordingly, this Committee should also be concerned about any significant adverse impact on existing title companies that might result from the widespread entry of lenders into the business of title insurance.

The competitive problems posed by the entry of lender-affiliated companies into the title insurance business derive not from the financial strength of large, nationally recognized lending institutions, or the ability of one institution to singlehandedly dominate the industry. Rather, they derive from the ability of each individual lender to channel the title insurance business arising out of its own mortgage lending transactions to its own captive title company. If mortgage lending institutions wanted to enter the title insurance business in order to compete for business they did not generate, the public policy implications of authorizing such activities would raise one set of issues on which differing views might be held. These are not, however, the problems that are of immediate concern to ALTA. What ALTA is concerned about are the consequences stemming from the fact that mortgage lenders who enter the title insurance business will be in a position to issue title insurance policies on their own loans. ALTA believes that this is the essential issue that must be addressed by Congress and that on this issue there cannot be any reasonable difference of views.

A title company owned by or affiliated with one or more lenders has an insuperable advantage in obtaining the business of its affiliated lenders that independent title companies cannot realistically expect to overcome. As explained in Part I above, consumers will inevitably accept the recommendation of a lender regarding the selection of a particular title company. Even if all the anti-tying prohibitions proposed in S. 2181 were adopted, it is virtually certain that a significant portion -- if not most -- of the lender's title insurance business would still be handled by its captive company. While independent title companies can attempt to compete for this business, it is unrealistic to expect that a loan officer of a lender would recommend the products and services of independent title companies when his institution has a significant investment in a title company whose profitability is dependent on a high volume of transactions.

Thus, the inevitable effect of the expansion of lenders into the title insurance business will be to create two classes of title companies. The first class would consist of those title companies that are owned by lenders and that, to a great extent, will be insulated from normal competitive pressures in trying to obtain business because they can expect to receive a high percentage of their title insurance business from their affiliated lenders. The second class would consist of those title companies that are not affiliated with lenders and that can obtain business only on the basis of the competitive merits of their products and services. As the number of lender-affiliated title companies increases, and the number of real estate transactions that are handled by lender-affiliated title companies correspondingly increases, the volume of transactions for which independent title companies can effectively compete will shrink, perhaps to the point at which many of the independent title companies will no longer be able to survive.

This market foreclosure problem, which exists to some extent when lenders get into other lines of insurance, is particularly severe in the case of title insurance. A title insurance policy is issued for a one time premium paid at the time the mortgage loan is made. There is no renewal market. The only competitive opportunities that exist for title companies are those at the time of the real estate transaction. Accordingly, the degree of market foreclosure faced by independent title companies will be determined by the number of lenders that decide to enter the title insurance business and the extent to which those lenders are able to place their own title insurance business with their affiliates.

The elimination of a significant number of independent title companies will obviously have an adverse impact on those lenders that choose not to establish captive title companies. Many of these lenders, for competitive reasons or otherwise, may be reluctant to have their mortgage loans insured by companies owned by their competitors. (This may be particularly true in areas of the country where title companies also close real estate transactions, since a mortgage lender may be reluctant to reveal the details of its mortgage lending transactions to its competitors or to give its competitors control over the disbursements involved in its loans.) These lenders will continue to have a vital interest in a viable, healthy, and independent title insurance industry, and their concerns over the impact that such market foreclosure may have on the financial strength and health of independent title companies should be taken into account by this Committee.

D. Risks to consumers.

In determining the public policy implications of expanding the powers of financial institutions, Congress must take into account the potential impact on consumers. ALTA believes that there are serious risks created for borrowers by lender ownership of title insurance underwriters and title insurance agencies.

First, as explained earlier, most consumers do not have the time, ability, or incentive to make an informed selection of a title company on their own, and thus rely upon the recommendation or referral of the mortgage lender or other real estate professional in the transaction. There is nothing inherently wrong with this. Indeed, when these recommendations or referrals are based on considerations that serve the consumer's interest -- price, coverage, service -- consumers benefit greatly from knowledgeable recommendations or referrals. In this setting, title companies will compete for the recommendations of the lender by trying to improve their products and services in ways that benefit the consumer.

On the other hand, when the mortgage lender is affiliated with a title company, it is inescapable that the lender's recommendation will not be made on the basis of considerations that serve the interests of the consumer, but will be made in order to increase the business of the lender's affiliate. As explained in Part I above, these problems will not be remedied by the anti-tying provisions contained in S. 2181.

A second problem created for borrowers by lender ownership of title companies derives from the fact that the borrower's interest in the property and in the protection he needs from a title insurance policy is not coincident with the lender's interests. While a title company that is owned by or affiliated with a lender will have a strong incentive to be certain that the lender's interest in the property is adequately protected, the same incentive does not necessarily exist with regard to the protection that the borrower may need. While the mortgage lender may be relatively unconcerned about potential claims or matters (such as minor survey problems or easements) that do not impair substantially the value of its secured lien, these claims or problems may be of concern to the borrower, who is interested in the peaceful use and enjoyment of the property. Thus, there is a serious question regarding the extent to which a lender-affiliated title company, whose business is provided to it by referrals from the lender, will feel constrained to provide the scope of protection to home buyers now offered by independent title companies that must compete for the public's business. This is particularly so when the lender owns the title insurance underwriter, since providing such protection to the borrower may result in greater costs or losses to the insurer -- and hence reduced profits to be returned to the lender that owns it. While sophisticated corporate borrowers may be able to protect their interests in obtaining the quality and scope of title insurance protection that they need, the occasional home buyer is not in this position. It is for this reason that there is a real concern that a title company affiliated with a mortgage lender -- a company that to a great extent is insulated from having to compete on the merits of its products and services for business that can be steered to it by the lender -- will not be subject to the same competitive pressures as independent title companies in providing protection to the purchaser.

Lender ownership of title insurance agencies may also adversely affect consumers because such arrangements tend to generate an upward pressure on rates. When a lender owns or is affiliated with a title insurance agency, it is in a position to direct a significant number of transactions to that agency. With such "guaranteed" business, the lender's affiliated agency is in an effective position to cause title insurance underwriters, who face very high fixed costs and who therefore place a great value on obtaining the significant volume of business that is controlled by lenders, to bid up the portion of the premium retained by the captive agent or to assume a greater share of the title-related work (and the attendant costs) normally undertaken by an independent agent in the issuance of a title insurance policy. Inevitably, the increased costs faced by title insurance underwriters in compensating captive agencies for their control over a significant volume of title insurance business will be borne by purchasers and sellers of real estate through higher title insurance rates. In this regard, the marketplace for title insurance could well become similar to that which exists with regard to credit life insurance, an area where serious overcharges have been well documented at numerous congressional hearings.[7]

Conclusion

In light of the risks and problems that will be created if mortgage lenders engage in title insurance activities, ALTA believes that Congress should not permit mortgage lending institutions to engage in title insurance activities. While ALTA supports the continuation of the existing restrictions on insurance activities of bank holding companies that are contained in section 4(c)(8) of the Bank Holding Company Act, the risks and problems discussed in this statement are not unique to bank holding companies. These risks and problems exist whenever any mortgage lender is in a position to issue or to have an affiliate issue title insurance policies insuring its own loans. In light of the conflicting ways that federal regulatory agencies have dealt with this problem, ALTA believes that Congress should apply restrictions similar to those contained in the Bank Holding Company Act to all other federally regulated financial institutions, including savings and loan holding companies, service

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7/ See The Consumer Credit Industry (Credit Insurance), Subcomittee on Antitrust and Monopoly of the Senate Committee on the Judiciary, 90th Cong., 1st Sess. (1967); Subcommittee on Financial Institutions of the Senate Committee on Banking and Currency, Hearings on S. 1754 (Consumer Credit Insurance Act), 91st Cong., 1st Sess. (1969); Hearings on Credit Life Insurance, Subcommittee on Antitrust, Monopoly and Business Rights of the Senate Committee on the Judiciary, 96th Cong., 1st Sess. (1979).

corporations of savings and loan associations, and federally insured state-chartered institutions.

If Congress should ultimately decide, however, to permit affiliates of mortgage lending institutions to engage in insurance activities generally, ALTA believes it is absolutely imperative that prohibitions be placed on the ability of those affiliates to insure the loans of their related mortgage lending institutions.

Finally, because of the complexity of the public policy issues that must be resolved in deciding what activities should be permitted for federally-regulated financial institutions, it is possible that Congress will need additional time before it can establish legislative policy in this area. If this appears to be the case, we urge that Congress impose a moratorium on further changes in the market, whether brought about by financial institutions, federal regulators or state regulatory bodies, until Congress is able to resolve these issues in a manner that will ensure the continued safety and soundness of the nation's financial institutions.

ATTACHMENT

Internal FDIC Memorandum, August 29, 1946

August 29, 1946

Exhibit "52"

MEMORANDUM TO-
The Special Committee
and
The Board of Directors

Re: Proposed Substantive Rules.

The subcommittee on the Substantive Rules recommends the adoption of three new substantive rules and one amendment to the Corporation's present substantive rules. These recommendations and the reasons therefor are as follows:

A. Proposed New Rules

(1.) PART 3-- POWERS INCONSISTENT WITH PURPOSES OF FEDERAL DEPOSIT INSURANCE LAW.

> Section 3--.1 Inconsistent powers. A State nonmember insured bank (except a District bank) which does not have any of the powers hereinafter enumerated, or which, although it has any such power, does not exercise the same, shall not hereafter exercise, take, or assume the power: (a) to do a surety business; (b) to insure the fidelity of others; (c) to engage in insuring, guaranteeing or certifying titles to real estate, or (d) to guarantee or become surety upon the obligations of others.[1]
>
> Section 3--.2 Exercise prohibited. After the effective date of this regulation, any State nonmember bank (except a District bank) becoming an insured bank shall not thereafter exercise any of the powers enumerated in the preceding section.

Reason for Proposed Rule.

The Board has consistently held that the powers listed above are inconsistent with the purpose of our Act. Banks which have been admitted to insurance since the Banking Act of 1935 have been required either to amend their charter so as to eliminate such powers or have been required to agree that they would not exercise such powers so long as they were insured banks. The Board having imposed such condition on banks admitted subsequent to the passage of the Banking Act of 1935, in the opinion of the committee, should prohibit other insured banks which are not now exercising such powers from so doing.

Since the above powers are inconsistent with the purpose of our Act, and insurance may not be granted to a bank whose powers are inconsistent, it is the opinion of the committee that the Board has the authority to issue such a regulation under its general power to issue regulations. (Subsection (j) Tenth).

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[1] The limitations prescribed in clause d do not include acceptances or endorsements made in the usual course of the banking business.

(2). PART 3-- EXTENSION OF CORPORATE POWERS.

> Section 3--.1 Classification of general character of business. State nonmember insured banks are divided into six categories for the purpose of classifying their general character or type of business,[1] viz: commercial banks, banks and trust companies, trust companies (without banking powers), savings banks, (including mutual and stock), industrial banks, and cash depositories.
>
> Section 3--.2 Change in general character of business. No State nonmember insured bank (except a District bank) or branch thereof shall hereafter cause or permit any change to be made in the general character or type of business exercised by it after the effective date of this regulation without the prior written consent of the Corporation.

Reasons for Proposed Rule.

Subsection (g) of our Act prescribes the factors to be considered by the Board in admitting a State nonmember bank to membership. These factors include the financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, and the convenience and needs of the community to be served by the bank. When a bank applies for insurance the Board gives consideration to each factor in the light of the bank's powers at that time. Should the bank subsequently enlarge its corporate powers or change the general character of its business it may materially affect the basis upon which the Board considered the factors and the bank would be exercising different rights, powers, and type of business from that considered by the Board. The committee is of the opinion that the Board has authority to issue such regulation under its general power to issue regulations. For a futher and more complete discussion of this proposal, see memorandum of Counsel, G. J. Oppegard to Mr. Vance L. Sailor, dated July 25, 1945, (copy attached to original hereof).

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[1] A bank's business may include two or more of the general classifications.

(3). PART 3-- REMOVAL OF PRINCIPAL PLACE OF BUSINESS

Section 3--.1 Removal of principal place of business. No State nonmember insured bank (except a District bank) shall move its principal place of business without the prior written consent of the Corporation.

Reasons for Proposed Rule.

Under the provisions of subsection (v)(5) of our Act a State nonmember insured bank may not move a branch from one location to another without the prior written consent of the Corporation. No specific provision is contained in our Act with reference to the change in location of the principal office. This was clearly an oversight in the drafting of our Act. However, in admitting a bank the Board is required to consider the needs and convenience of the community as well as the adequacy of the bank's capital structure. Should a bank be free to move from one location to another the basis upon which the Board considered the factors would be materially changed. It is, therefore, deemed by the committee to be necessary to prohibit by regulation a bank from moving its principal place of business for the reason set forth above. The committee is further of the opinion that the Board has the authority to issue such regulation under its general power to issue regulations.

B. Proposed Amendment to Existing Rules.

1. Amend Section 303.4 of our present regulations, relating to penalties, by striking the last sentence thereof.

Reason for Proposed Amendment.

The Banking Act of 1933, as amended, by Public Law No. 362, 73d. Cong., June 16, 1934, provided that the board of directors could by regulation impose a maximum penalty of $100 for each day an insured bank continued to violate any lawful provision of our advertising regulation. Pursuant to this provision the Board incorporated in our original Regulation III (now Part 303 of our present regulations) the following: "No penalty will be imposed for any violation of the provisions of this part until the bank has been given an opportunity to be heard before the board of directors of the Federal Deposit Insurance Corporation." The Banking Act of 1935 amended the provisions of the 1933 Act, as amended, with reference to this section and merely prescribe that "for each day an insured bank continues to violate any provision of this paragraph [(v)(2)] or any lawful provision of said regulations, it shall be subject to a penalty of not more than $100, recoverable by the Corporation for its use." By this amendment the necessity for a hearing before the board was eliminated but the regulations were never amended. It should now be so amended by striking the above referred to sentence. By so doing it will make the provisions of this regulation consistent with the provisions of our regulation Part 304. The law in both cases is identical and the regulations should be consistent.

It is further recommended that the foregoing proposed regulations and amendment be adopted at the earliest practical date in order that the same may be immediately filed for publication in the Federal Register.

APPROVED:

James McKane
James M. Kane
Solicitor

Edw. C. Tefft

Russell E. Shearer
Russell E. Shearer

Charles B. Aycock
Charles B. Aycock

Vance L. Sailor
Vance L. Sailor
Chairman, Subcommittee

Approval of foregoing recommended by Special Committee to Board of Directors:

P.G.

VS

E.W.T.

J.J.D.

L.L.R.

A.J.J.

Statement of Donald P. Kennedy,
President of the American Land Title Association,
Before the Senate Committee on Banking,
Housing and Urban Affairs
March 6, 1984

Mr. Chairman, my name is Donald P. Kennedy and I am President of First American Title Insurance Company of Santa Ana, California. I am appearing today, however, in my capacity as President of the American Land Title Association, an association whose 2,000 members include title insurance companies, title insurance agents and abstracters. I have a more detailed written statement of our position that I request be included in the hearing record.

As a preliminary matter, let me say that our Association concurs in the views that have been expressed by representatives of the other segments of the insurance industry regarding the need for the continued separation of the banking and insurance industries. In my limited time today, however, I would like to focus attention on several issues of particular concern to our industry that have not received the attention they deserve: namely, the risks and problems that will be created if affiliates of banks and other mortgage lending institutions are permitted to enter the title insurance business and are allowed to insure the mortgage loans of their affiliated lenders. These risks and problems directly affect the safety and soundness of such institutions and threaten the continued healthy functioning of the secondary mortgage market.

Before discussing these risks and problems, several brief points by way of background may be helpful to your understanding of the concerns of our Association.

First, title insurance is issued only in connection with a real estate transaction, which usually involves mortgage financing. For a variety of reasons, including the need to minimize the risks associated with their mortgage lending activities, the vast majority of mortgage lending institutions require title insurance to protect the validity, priority and enforceability of the liens that secure the billions of dollars they have invested in mortgage loans.

Second, in contrast to other forms of insurance, where the underwriting of risks is generally based on actuarial predictions of the likelihood of unknown and unknowable future events, such as a death, an accident or a fire, the underwriting of a title insurance policy, which protects against claims and problems arising from past events or transactions, involves a thorough examination of the records and documents relating to those past events and transactions in order to determine the status of the title to the particular property to be insured and the liens, claims or encumbrances that may exist with respect to that property. These underwriting functions require both access to local land records and an intimate knowledge of applicable local law affecting real estate transactions. Accordingly, title insurance underwriters must either maintain direct operations at the local level to perform these underwriting functions or must arrange to have these functions performed by title insurance agents who have the capability to maintain such local operations. It is critical to an understanding of the special problems that attend the entry of mortgage lenders into the title insurance industry to appreciate that, unlike agents in other lines of insurance who perform essentially sales-related functions, title insurance agents are responsible for the substantive underwriting determinations that have to be made in connection with the title insurance policies they issue on the underwriter's behalf.

Third, whereas consumers purchase other types of insurance on a periodically-renewable basis and can always change insurers if they can obtain better rates or coverage, this is not the case with title insurance, which is sold for a one-time premium and protects the insured owner for as long as he has an interest in the property. Accordingly, consumers generally purchase title insurance only once or twice in their lifetimes -- usually when they buy a home. For understandable reasons, they are far more concerned at that time about other aspects of the transaction (primarily obtaining mortgage financing) than they are about becoming knowledgeable shoppers for title insurance. Consequently, because of a lack of time, knowledge, and incentive (since the cost of title insurance is relatively small in comparison to the other costs incurred in the transaction) most consumers tend to rely on the recommendation of a real estate professional, frequently their mortgage lender, in selecting a title company.

Appreciating these characteristics of title insurance will help the Committee in understanding the risks and dangers that will be created if affiliates of mortgage lending institutions are allowed to issue title insurance policies on those institutions' own mortgage loans.

Risks to the Safety and Soundness of Mortgage Lending Institutions

Mortgage lending institutions recognize -- as do the agencies that regulate them -- that the security of their mortgage loans is essential to their continued safety and soundness. Over the last several decades these institutions have, with increasing frequency, come to rely upon title insurance as an effective means by which they can transfer to third-party insurers the title-related risks of the billions of dollars in mortgage loans they make each year.

In insuring such loans, it is essential that professional and independent underwriting judgments be made regarding the nature of the titles underlying these loans, whether such loans will be secured by valid and enforceable liens, and whether and the extent to which certain matters can be insured against prudently. That independence cannot exist if the title company is owned by or is an affiliate of the lender whose mortgage loans it will be insuring. Indeed, there is a real question as to whether a lending institution is truly "insuring" the title-related risks of its mortgage loans when those risks are placed with a captive insurer of the lender or its holding company. Insurance is, by definition, the transfer of the economic consequences of risk from one party to another. When a lender transfers the title-related risks of its mortgage loan portfolio to a subsidiary or affiliate, it may appear that it has "insured" those risks, but in fact it has merely transferred those risks from one corporate pocket to another.

Moreover, there is a fundamental, inherent conflict of interest when the title company making the underwriting determinations on a lender's title insurance policy is owned by or is related to the lender whose loan it is considering insuring. This conflict of interest is particularly acute when the lender or its affiliate seeks to act as a title insurance agent in connection with the lender's own mortgage loan transactions. In such a situation, the lender-affiliated agency faces a clear conflict between the interest of its affiliated lender in obtaining the maximum degree of title insurance protection under the insurance policy that will be issued to it and the interest of the underwriter -- for whom it is acting as agent -- in assuming only prudent risks.

Risks to the Continued Healthy Functioning of the Secondary Mortgage Market

Mr. Chairman, the Committee is no doubt aware of the critical importance of the secondary market to the continued availability of mortgage money to consumers and other purchasers of real estate throughout the United States. What the Committee may not be aware of, however, is the essential role that the existing, independent title insurance industry has played in fostering the phenomenal growth of that market. The underlying and, indeed, ultimate security for the tens of billions of dollars in mortgage loans purchased in that market is the validity, priority and enforceability of the liens securing those loans. Purchasers of such loans universally require title insurance not just because of the financial protection it provides in the event of a title-related claim or problem, but because of the knowledge that before the policy is issued a thorough, professional, and independent examination will have been made of the title and of various matters that might affect the security of those mortgage liens.

Consider, if you will, the potential long-term consequences if the title companies that will be providing the title insurance protection on those loans are owned by or affiliated with the originating mortgage lenders who sell such loans in the secondary market. Can there be a clearer conflict of interest than where the title company responsible for determining and insuring the validity, enforceability and priority of the lender's mortgage lien -- and on whose independent and professional judgment the purchaser of the loan will be relying -- is affiliated with the lender who is selling that loan and who has an obvious interest in making that loan appear to be as marketable as possible? It may be difficult to predict the precise consequences of such conflicts on the willingness of investors in the secondary market to continue to purchase mortgage loans. I suggest to the Committee, however, that the enactment of legislation that would permit and, indeed, encourage such conflicts can only result in adverse consequences for the secondary market. Given the interdependence between the secondary market and the housing industry, any problems created by those conflicts for the secondary market are likely to have profound implications for the housing industry itself.

Risks to Competition and Consumers

Mr. Chairman, in view of my limited time, I cannot address the many competitive and consumer problems that would be created if mortgage lenders obtain effective control over the underwriting of title insurance policies issued in their own loan transactions. Those problems are, however, discussed at length in my written presentation.

Let me just say, however, that the competitive concern that worries our members is not that independent title companies will be unable to compete with lender-affiliated title companies for what I might call "third party" or "public" business, i.e., business where the mortgage loan is made by a lender who does not have an affiliated title company. Our members believe they can compete effectively for that business. Realistically speaking, however, independent title companies cannot compete for the business of lenders who have established affiliated title companies. Consequently, as the number of lender-affiliated title companies increases, the competitive opportunities remaining for title companies that are not affiliated with mortgage lenders will correspondingly shrink, perhaps to the point where few if any independent title companies can survive. The demise of the existing, independent title insurance industry -- which is a possibility if most or even many mortgage lending institutions decide to establish captive title companies -- would have potentially disastrous consequences for all mortgage lenders and investors in the secondary market, and for the public in general.

Conclusion

ALTA believes there are sound and persuasive arguments as to why existing restrictions on the insurance activities of bank holding companies should not be removed, and indeed, why Congress ought to apply similar restrictions to the insurance activities of other federally-regulated financial institutions as well. But our more fundamental concern, and the position we most strongly urge on this Committee, is that banks and other mortgage lending institutions should not be permitted to establish affiliated title insurance entities that will issue policies on their own mortgage loans. Whatever incremental profits it may appear will be provided to mortgage lending institutions (or their holding companies) by allowing affiliates to handle the title insurance business of their related lending institutions, such marginal benefits will be far outweighed by the longer-term adverse consequences to the continued safety and soundness of those institutions, to the continued healthy functioning of the secondary mortgage market, to the soundness and stability of the existing title insurance industry, and to the consuming public.

I might also say, in concluding, that if the Committee believes that the public policy questions raised by the issues it is considering cannot be resolved in the near term, ALTA believes that a moratorium should be imposed to prevent further changes in the market -- whether brought about by financial institutions, federal regulators, or state legislatures or regulatory bodies -- until Congress does decide whether and the extent to which financial institutions and their holding companies should be permitted to engage in widespread new activities.

The **Chairman**. Mr. Mitchell.

STATEMENT OF BRADFORD W. MITCHELL, VICE CHAIRMAN OF THE BOARD, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS; CHIEF EXECUTIVE OFFICER, HARLEYSVILLE, MUTUAL INSURANCE CO., HARLEYSVILLE, PA.

Mr. **Mitchell**. Thank you, Mr. Chairman. I shall try to be brief in view of the hour.

Mr. Chairman, members of the committee, I am Bradford Mitchell, chief executive officer of Harleysville Mutual Insurance Co. of Harleysville, Pennsylvania. I am testifying today on behalf of my company and the more than 500 property/casualty companies in the National Association of Independent Insurers, which I serve as vice chairman.

S. 2181, the Financial Services Competitive Equity Act, addresses a few of our concerns to reach comparative equality in the marketplace. However, we believe our apprehensions deserve further consideration.

In our judgment, regulatory parity is a distant, if not impossible, goal for those who would integrate the banking and insurance industries. Therefore, banks should be prohibited from insurance underwriting until parity is accomplished. If and when banks are given the authority to underwrite insurance, it must be done through a separate corporation and regulated entirely by the state insurance departments without federal preemption or examination into insurance operations. Conversely, insurers must have equal market access to the business of banking subject to the regulatory bodies and rules applicable to banking.

The states and their insurance departments have proved to be capable and diligent regulators, and they should not be undercut or displaced. Their laws and rules governing underwriting, claims handling and unfair trade practices, the tests of financial soundness and many other safeguards have been carefully assembled and elaborated, over many years of experience, for the purpose of protecting the public by casting a spotlight on insurers' operations. To permit any insurer to escape this scrutiny, or to cover or camouflage its operations within a huge conglomerate, is a dangerous mistake.

We are also deeply troubled by active or passive tie-in sales. Banks now occupy a privileged position because of their control of credit. To give them an extra competitive edge by offering the potential for tie-in sales, and trusting that no one will abuse the potential, is not equitable.

Much has been said about "level playing fields." My company is a medium-sized, regional, multi-line insurer that writes about $280 million in premiums annually and serves 500,000 policyholders. We are realistic enough to know that we can't really compete on a level plane with a Citicorp or a State Farm. But we can compete in our bailiwick, and in rough and muddy parts of the field. What we need is a fair referee -- the state regulator -- who will apply the rules of the game impartially. And that is not possible when one player, whether by law, oversight or implication, receives an added measure of control over the sales transaction.

Inequity of that kind would tip the scales against small and medium-sized insurers, who are struggling in an already-tough competitive climate. Many would not survive and the result would be an illegal and unhealthy concentration of economic power in the hands of a few giant institutions. Such an outcome would be all the more intolerable it it were carried out for the ostensible purpose of deregulation, which is supposed to foster competition, not kill it.

Finally, much more study should be given to the integration of two thoroughly different businesses like insurance and banking. Banking is a very stable enterprise. Neither bankers nor banking regulators have had experience with the highly volatile business of insurance nor are they equipped to assess the abilities and resources of a new insurer to succeed. Many specific technical questions remain unaddressed. For instance, last year, 48 banks failed. Once integrated, will a bank holding company be allowed to siphon off insurance assets to help another ailing subsidiary? If an integrated insurer becomes impaired, will it be permissible for a parent company to doctor the insurer's reserves with paper they are holding on loans to Poland and Mexico?

Until these and many other issues are settled, we believe it is prudent to move a step at a time toward integration. My company and the NAII are ready and eager to assist the committee and the Congress in any way we can.

Thank you.

The CHAIRMAN. Thank you, Mr. Mitchell.

THE MATTER OF CONCENTRATION

Mr. Carter, you and other members of the panel expressed a great deal of concern about concentration, but once again, as with the previous panel, it's concentration in only one area. I hope you were here and even if you weren't I'm not going to repeat that whole dialog, but the issue of concentration is constantly raised and yet it's interesting to me and to back up what I said before I am concerned about concentrations in any segment of the financial services industry, not just banking. But it's interesting that in 1982 of the $5.6 trillion of credit market debt outstanding in the United States, commercial banks held only 26 percent of that outstanding debt.

Also, the figures in 1980, the top 10 life insurance companies held 52.5 percent of all the assets of all the life insurance companies in this country. In 1982, the top 10 firms in the securities area managed 82 percent of the total dollar volume.

Try looking at 14,000 banks and savings and loans and credit unions—well, just look at the banks—concentration isn't nearly as great as it is in the insurance industry already and in the securities industry.

How do you respond to that?

Mr. CARTER. First, Mr. Chairman, you should consider what the trends are because I think the trends are in what we would consider the right direction. I'm very sure that's true in the life insurance industry. I'm not that certain in the brokerage industry.

For example, if you look at the market share that those top few insurance companies have you will see that while the number of life insurance companies has more than tripled since 1950, the market share of new business of the eight largest firms has dropped by almost 50 percent. Incidentally, if you divide 10 into 52 you come out with 5 percent of the market, and even if there are only 20 players, that's a reasonably competitive picture as compared to the automobile industry, or the steel industry, or something like that.

The CHAIRMAN. Well, I'm specifically talking about the banking industry and if you take the 10 largest banks, they don't have 52 percent of the assets of the banking business, not by a long shot, whatever the trends are.

All I'm trying to do is make the point again that we constantly hear the bogie man that there's a fear of concentration in the banks. I agree. I do not want a few large banks that control the financial services industry, but I have to keep going over and over the fact that there is a potential for concentrations in other industries as well, and as of the current figures, insurance companies have a great deal more concentration and securities firms than the banking industry. Yet I hear from both sides worry about the concentration in banks.

I'm worried about all three.

Mr. CARTER. I agree with you, Mr. Chairman. You should be worried about all three. Any citizen should be worried about all three. But it's that credit lending power that the banks have that make them unique and cause us to focus more on that question than on the other two or any other industry.

Mr. MOSELEY. Mr. Chairman, there seems to me to be one other point in terms of the lack of concentration in the banking industry as compared to the insurance industry. While I certainly would agree with you that there's great concern for concentration wherever it's found, the banks perhaps are not as concentrated simply because they have not been allowed to cross the State borders into interstate banking to any degree other than in the credit card application which has occurred in recent years.

I think you would see a tremendously different picture if we had interstate banking or as soon as there is interstate banking if it comes.

So I think there is some reason to fear a large buildup in concentration among a dozen or so banks in the country.

As far as the vast majority of the banks around the country, I would agree that there is no bogie out there that we have to be concerned about. But among the dozen or so largest banks, there is something to be concerned about in the future if you change the rules.

The CHAIRMAN. Would any of you support legislation that would require insurance companies to divest themselves of their nonbank banks?

Mr. MOSELEY. I certainly would personally, yes, sir.

Mr. CARTER. Mr. Chairman, speaking on behalf of the ACLI, which, being a large trade group, represents members with diverse positions on this issue. I think you would be very pleased with the way the organization and its various members, including those with nonbank banks, would behave if legislation were to equalize all aspects of the financial services industry.

The **Chairman**. But you do favor divestiture then so that you're on both sides of the coin, not just one side? You don't want banks in your business but you're willing to get out of their business?

Mr. **Carter**. I think we need the full equation before we would be able to answer that question, but I suspect we would come to an affirmative answer.

The **Chairman**. What's the justification for the various insurance companies getting involved in nonbank banks to begin with? Who drove them to do that?

Mr. **Carter**. The chaos in the marketplace, the lack of regulation and competitive factors require those of us in the marketplace to move in that direction. It is still possible to sort out that marketplace and the U.S. Senate is powerful enough to do it.

The **Chairman**. But see, the total implications of the hearings today is these banks demanding these new services, and yet you just testified that there's the McFadden Act—you can't cross State lines. What would the insurance business be like today if Equitable had been told, "Sorry, you've got to operate in the State you're incorporated in and you can't sell insurance in Utah and you can't do it someplace else, reserve requirements, geographical restrictions, all sorts of things." And so now banks are asking for some competitive equity. Why do the insurance companies feel they needed to have nonbank banks and get into deposits and so on? Why did Merrill Lynch?

LOOPHOLES BROUGHT ABOUT NONBANK BANKS

Mr. **Carter**. Again, I think the breaches that have occurred in the regulatory barriers have simply allowed institutions to go into new areas. I don't think the fact that institutions have gone through a given breach makes it right. There were a number of bank holdups last year. I don't think it's the province of this committee to legalize that exciting profession.

Mr. **Moseley**. I certainly hope not because I insure a lot of them.

Senator, getting to the point of why an insurance company might have gone into a nonbank bank, I think Mr. Carter is absolutely right. If there's a hole in the dike, somebody is going to walk through it. That doesn't make it right. As I said earlier, no one should be able to preempt Congress simply because Congress momentarily turns its back. I think that Congress does have a right to say that they are concerned about concentration of power. Congress is concerned about what industries should be in the banking business and what industries should not be, that the separation between banking and commerce should be upheld, and while I cannot speak for all the members of the American Insurance Association, I surely would support legislation which would call for divestiture, if that would get us to a situation that was fair.

I'm always amused by the term "level playing field" because it's a round world. [Laughter.]

The **Chairman**. Well, you gentlemen understand what I'm driving at. It obviously appears to you that maybe I'm sitting up here taking the banks' position, but if the situation were reversed and banks have been out getting into the insurance business, securities, and all sorts of things through some loophole or whatever legal means they could, and then the other industries were coming back with prohibitions and said you can't do this and that's unfair, I would be asking the same type of questions.

I'm trying to address the entire problem and not the specifics of any one segment of the industry. I don't know. Maybe it's more popular to just attack big banks and it's certainly easy to come in and talk about safety and soundness and uniqueness.

Gentlemen, being in the insurance business for a good part of my adult life, I'll guarantee you, I've got a lot more money in cash values of my life insurance than I've ever been able to accumulate in a savings account, and that is generally true. I used to make that argument when I sold insurance—yes, it's better to buy term and invest the difference, but you won't invest the difference. I know all the arguments.

But the fact of the matter is that it is true of most people. They've got more savings in their life insurance than they have in any account because it's forced savings and it's the most money most people will ever accumulate in their life except the equity in their homes.

So I'm interested in the safety and soundness of my life insurance, too. I want it to pay if I die and I want the cash values to be there if I live and I hope that's the way it is. So safety and soundness and the uniqueness and the responsibility of protecting the depositors, I felt that was incumbent upon me as an insurance salesman too, that I could guarantee my customers that it would be around when they got there.

So wouldn't you agree with that, that you have a fiduciary responsibility and an obligation for safety and soundness as well in the insurance business, and that's rather unique because a lot of people are absolutely depending at a very critical time on that money being there.

Mr. **Carter**. I absolutely agree with you, Senator. When you made those 40, 50, and 60 year promises to those people you sold insurance to, you assumed that your company was investing its assets in a way that would insure the delivery of those promises at those future dates. It would not be prudent to tie in those promises with loans in Brazil or Mexico.

Mr. **Moseley**. There's another aspect to that, too, Senator, in that the insurance industry does have a privately financed way of assuring that safety called State guaranty funds. We may not always like the way they work, but they are efficient in getting money out of us for a poorly run company that goes under. I think that is a commendable approach in the sense that the public is not being called upon to pay the cost of that safety.

That's not true in banks. The FDIC can ultimately fall back on the public to pay for poor management, if you will. On the other hand, if it really is desirable to have banks in the insurance business and insurance in the banking business, then let's open up the FDIC to all others and give us all the chance at the discount window and let's have at it, the water's fine. [Laughter.]

The **Chairman**. Mr. Carter, in regard to loans to Brazil, that has something that's a little more far reaching than the discussion today. It's a matter of jobs in this country, foreign trade, sale of U.S. products. We do have a trade deficit and I seem to remember that a lot of these loans were absolutely demanded by politicians and others in this country to become energy independent—we've got to get away from the OPEC nations. But politicians have very short memories. None of them will admit anymore to encouraging a lot of those loans be made so that we could develop oil in Mexico and so on.

The international trade situation gets far beyond our discussions today but I don't think it's fair to leave hanging that some of those international loans should not be made. Some of them certainly should not have been made on the terms they were. Some of those loans were irresponsible. But in the general sense, we can't stay isolated within our own country and not participate in the international financial markets.

As far as the FDIC, certainly there is insurance there and it is paid for. It is not taxpayer supported, and it needs to be noted as far as the number of failures in banks last year and the year before, there was a large number of bank failures handled rather well through mergers rather than paying out up to $100,000 of insurance, which would have been far more costly and in some cases could have wiped out the entire FDIC fund.

But through one of the more difficult times in our financial history, the FDIC fund, despite arranging those mergers, the fund increased in size. At the end of that period of time, rather a remarkable performance during a very difficult period of time, to have the fund larger at the end of those failures than it was at the beginning, but we're branching off into another area of the Banking Committee's jurisdiction that's not directly related to whether banks get involved in the insurance business or not.

DEREGULATION'S EFFECT ON BANK FAILURE

One other comment I would like you to expand upon, partially again the bogy man of deregulation is linked to bank failure. Again, I will go back through what I said earlier. Certainly none of the bank failures that we have looked at have had anything to do—there hasn't been time. Maybe at some time in the future you can come back and show me one when it's had longer to go, but there is none at this point. It had nothing to do with it whatsoever.

But I would ask you the question, Mr. Moseley, what would have happened to a lot—particularly not banks—but savings and loans, if they had not been given some expanded powers? If you want to look at the list of troubled institutions in an industry that was on its back because of regulation and being required to borrow short and lend long in the homebuilding industry, it was the S&L's industry. You had the potential of losing an industry, not just a few institutions. There were more than 1,000 potential mergers in 1982. They handled more mergers in 1 year in the Federal Home Loan Bank Board than in the entire history of the Federal Home Loan Bank Board during that period of time.

So I ask the question, Without deregulation in the sense of what we did before, not what we're talking about doing in the future, how many failures would there have been?

Mr. MOSELEY. I have no way of knowing, but I'm sure it would have been many, Mr. Chairman. But, on the other hand, what were those expansions was that helped save them? My recollection is that much of the expansion was in giving more authority in the commercial banking area, not necessarily in the insurance area or other forms of business.

The CHAIRMAN. They already had the insurance, savings and loans.

Mr. MOSELEY. Well, they have principally the credit insurance. There is very little other forms of insurance.

The CHAIRMAN. You're correct, it is primarily expansion of commercial authorities. But the point I am making is trying to get the insurance industry to confine their remarks to their area of expertise, to the section of the bill that deals with insurance and not expand it to the whole process of deregulation. And I know that is not your intent in your testimony, but both of the last panels, the insinuation has been that the whole process—we're talking about a lot of things in S. 2181 that I'm sure you have not read and you could care less and it has nothing to do with it.

So I'm just trying to confine you back to the area of your expertise, great expertise in the insurance field, and that's why I asked Mr. Jones, I wanted to clarify his point about opposition to S. 2181 when his opposition is to parts of S. 2181. That's what I'm trying to drive you back to so that you're not causing any trouble in getting Congress to set some national policy on areas that have nothing to do with your areas of concern. The same thing with the agents that were here before you.

Mr. MOSELEY. Mr. Chairman, I certainly hope I made quite clear that we do oppose banks coming into the insurance business.

The CHAIRMAN. Oh, yes.

Mr. MOSELEY. But I don't care whether they go into the oil business, although I might withdraw that. I suspect I would.

The CHAIRMAN. Well, nobody is advocating that they get into the area of general commerce, no one that I know of.

Mr. MOSELEY. But on the other hand, I would say, as some of the other people here have said, if Congress wants to act to open up all areas to both banks and the insurance industry, that is an entirely different subject and we should discuss that.

The CHAIRMAN. Well, I understand. I appreciate your testimony. My time has expired and I want to turn to Senator Dodd. I would just say that I'm hopeful in this process, as I was successful in 1981 and 1982, at one time or another to have stepped on everybodys' toes from every segment of the industry so that everybody was a little bit upset with me and doesn't like what I'm doing. If I've done that, then I will feel that I am walking a careful line of being unbiased. Because if any of you come in and say that you think this is just wonderful, obviously I've gone too far in that direction. I'm not being facetious. Obviously, each segment of the industry is expected and should come in and defend your position. If you don't, no one else is going to do it for you. That's for sure.

But in the final analysis, in order to try and make any sense out of the chaos that is in the marketplace, we have to go through a process, as we have before, of being willing to give and take and not being totally satisfied with what the final legislation is, be willing to make some compromises for the overall financial services industry.

So don't misunderstand some of my questions. Some of them are playing the devil's advocate. I do it with all of the groups to try and draw them out and hopefully at the end of this process be able to achieve a general consensus that nobody is totally happy with and nobody is totally opposed to either. Otherwise, it just goes on with no action being taken at all.

Mr. Jones, did you wish to make a comment?

Mr. JONES. Mr. Chairman, I think that our statement points out abundantly clear the point that you were just talking about, certain sections of S. 2181. The alliance board has taken a little different posture, we feel, from the rest of the industry. We do not object to banks getting into the insurance business. We have established about six different criteria and we feel that if that criteria is amended or worked into the bill that we would not object. We would not support the legislation, but we would not object to the banks getting into the insurance business.

We also feel that if banks have the opportunity to get into our business that we should have the opportunity to get into their business.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman. First of all, I apologize to you and the witnesses for being a few minutes late. I have a statement, Mr. Chairman.

The CHAIRMAN. Just a few minutes—he was 1½ hours late. [Laughter.]

STATEMENT OF SENATOR DODD

Senator DODD. That's Utah time. I was about to commend you but I will amend my commendation for holding these hearings and facing this Gordian knot of financial institutions and trying to come up with some intelligent approaches to what we need.

Mr. Chairman, I am pleased to welcome today's witnesses to this hearing. Today we will be hearing from representatives of the insurance industry. As everyone knows, insurance is a major industry in my home State of Connecticut and, like other financial services, has been profoundly affected by the rapid changes occuring in the financial industry as a whole.

In fact, these changes are so widespread and have received so much public attention that today we discuss them with cliches. "Nonbank banks," "South Dakota loopholes," "Glass-Steagall" and "McFadden" have all come to symbolize major issues facing the financial industry. Furthermore, they have come to highlight significant points of departure from decades-old conventions as to safe and sound banking practices.

It is frequently argued that Congress should rewrite Federal financial services law to conform to the various new market realities in that sector. Given the confusion that currently reigns, I am inclined to share that view. However, I disagree with those who suggest that the primary purpose of rewriting these statutes should be to ratify these changes. The financial industry, depository institutions in particular, plays a unique role in the economy through its dealings in a unique commodity—money and credit. The historical record clearly illustrates the ramifications of excessive instability, concentration and speculation in the financial sector. Therefore, it is up to Congress to not only recognize the changes that are occurring in the financial sector, but to help shape its future. It is just as important to avoid undue concentration, risk, and conflict of interest as it is to promote regulatory equity among competing financial institutions. Safety and soundness are especially deserving of top-priority consideration, given the role of depository institutions as a conduit for monetary policy. These issues must not be subordinated to parochial concerns over simple market share.

Mr. Chairman, I commend you for continuing to raise these issues and I am sure that our witnesses, both those here today and on other days, will do their best to make sure these issues are not forgotten.

I just have a couple of questions.

As you know, Mr. Chairman—I don't know if the panel knows—I am a cosponsor of the Heinz moratorium legislation. I am concerned a bit about it and I'd like to address a question to the panel about a suggestion I think, Mr. Kennedy, you made about a moratorium being something more permanent than something we have talked about earlier on the Heinz bill, and obviously that was provoked as a result of title VI of the Garn-St Germain bill, the South Dakota situation, and so I have a deep interest in what happens here.

Obviously, in Connecticut, the insurance industry is not a cottage industry.

But let me go back to a point that has been raised and you cited a couple of examples—the Brazilian loans, the Mexican loans, and so forth. But the word "risk" is used rather repeatedly. Mr. Carter, you talked about the Mexican and Brazilian situation.

RISKS FOR BANKS IN INSURANCE FIELD

Where else do you see the kind of risks we're talking about should the banking industry assume a great deal of responsibility in the insurance field? Are there other instances where you feel that risk is such that the consumers would be adversely affected? I'd ask for some very specific examples. I think we need them.

Mr. Moseley. Senator, I think there are quite a number of such examples. You start, first of all, with the capitalization of banks in terms of their own leverage and compare that to the insurance industry, and you begin to understand the nature of why we are concerned about risks a little better.

It is not unusual, particularly for the Nation's very largest banks, for their capital-to-asset ratios to be very, very low, less than 5 percent; in some cases, less than 4 percent. For regional banks out of the money center banks area, that average rate is 6.5 to 8 percent, but still highly leveraged as an industry.

Now, in contrast, an insurance company in the property and casualty industry is conceived to be overleveraged by many, and in particular by the State regulators, if their premium volume to surplus exceeds 3 to 1. Certainly it's put on the watch list and as it approaches 4 or 5 to 1, action may be taken.

So if the banks came in and perceived that they could use the money more broadly and more widely in terms of leveraging risks, without understanding the difference in the nature of the business, that in itself creates the first and most immediate risk.

After you get beyond that, you have to assume that if a bank goes into the insurance industry it would want to increase that as fast as it could, as we do.

If it used improper leveraging to do that, any change in their reserve picture could put them in an insolvency situation.

For example, a company writing $1 billion of fire and casualty business today, the average company would have—if they had $1 billion in trading volume, they would have between $2 and $3 billion in loss reserves stock. If its capital structure, on the other hand, was a half billion dollars, running 2 to 1, if you were 10 percent wrong in the loss reserves that are maintained, he's done away with 60 percent of his capital in one fell swoop.

On the basis of that, he now is writing at 5 to 1, not 2 to 1, and certainly has difficulty in accepting more risks or being certain that he can pay off what he has. That's what we're talking about.

Senator **DODD**. That's a very good point. Do any of the other panelists want to comment on that point with regard to the risk?

Mr. **KENNEDY**. Senator, in my limited area, title insurance, I see some inherent risks in allowing the banks to own title insurance companies who want to insure the risks of their loans.

Senator **DODD**. That's a conflict of interest?

Mr. **KENNEDY**. Conflict of interest, and I think that may—although it's hard to quantify—in the future create some difficulties in the secondary mortgage market.

Senator **DODD**. You had a good discussion for a few minutes with the chairman on the issue of concentration and, as I understand it—Jake, you correct me if I'm wrong here—but we have a limitation of 25 percent of capital that could be used to acquire another institution, enter another activity, and that 25 percent requirement is limited to about 25 of the major lending institutions under the present set of circumstances.

The **CHAIRMAN**. Well, not lending institutions, but financial institutions.

Senator **DODD**. But under the present set of circumstances. We're having, of course, the New England experiment, which apparently is being repeated in the Southeast and it seems to me we are going to be moving more to regionalization before we move interstate, but we're seeing a lot of mergers and accumulation of capital under single banners as a result of that particular effort.

What I'm curious about—my estimates are that there are some $154 billion in capital in the banking industry at present, 25 percent of that, of course, would be some $38 billion. We're going to be talking about a lot more than 25 percent very soon, and I'm wondering what sort of impact that would have on the insurance industry, those numbers, vis-a-vis the capital of the insurance industry.

I wonder if you might comment on that. Again, anyone who wants to.

CONCENTRATION OF CAPITAL'S EFFECT ON COMPETITION

Mr. **MITCHELL**. Senator, I think that certainly the concentration of capital would have an effect on the competition. From my own company's point of view—and I've indicated that we are a middle size or medium size company—it's not the competition with the large capital competitor. We do that at the present time—Harleysville versus State Farm, if you will or Allstate.

The problem that we see, however, is the unfair competition. If you allow that large capitalized competitor to have that credit tie-in advantage, we're not on an equal plane in getting that piece of business. We're at a disadvantage in competing, not because of the money that he has, but because of the hold on the prospective buyer that he may have.

Senator **Dodd**. So the concern is more in that area. Do you all agree with that, by the way? You're not worried so much about the comparison between assets?

Mr. **Moseley**. That's right.

Mr. **Carter**. Yes.

Mr. **Moseley**. Senator, I do think you're referring to capital and not assets.

Senator **Dodd**. That's correct. I corrected myself when I said that. The chairman asked you about nonbank banks and three of you responded to that question. Mr. Kennedy and Mr. Mitchell, I didn't hear you respond about whether you would be willing to accept a limitation on nonbank bank activities.

Mr. **Mitchell**. Yes.

Senator **Dodd**. You may have answered that. I'm sorry if I didn't hear you.

Mr. **Mitchell**. I think you're correct. I did not voice an answer to the chairman's question. No, by all means, if that was deemed appropriate, to return the competitors to equal status, we would endorse that type of proposal.

Mr. **Kennedy**. I would agree, and I hope our association would, too.

Senator **Dodd**. You would hope it would?

Mr. **Kennedy**. We haven't addressed that yet.

Senator **Dodd**. You're not speaking for them then?

Mr. **Kennedy**. On that subject, I'm not.

Mr. **Jones**. We haven't addressed that issue either.

Senator **Dodd**. I thought I heard your answer to that earlier. You said you would be willing to allow it, but under certain conditions or criteria.

Mr. **Jones**. But you were speaking to nonbank banks.

Senator **Dodd**. I'm sorry. I thought you were including both when you responded.

Mr. **Jones**. No.

Senator **Dodd**. The moratorium legislation, as I mentioned, the Heinz bill, Mr. Kennedy, I don't know if you're the one responsible, but anyway, in your concluding statement you said that you felt if Congress couldn't resolve these issues—and I have great admiration for the chairman and his hope that he can, but there's some question about whether or not we're going to be able to, but I'd certainly like to see that happen.

The **Chairman**. I would like to say that the Senator expressed the same doubts in 1982 and particularly you and Senator Dixon were very helpful in making it come to pass, and I would expect that same kind of help this year.

Senator DODD. We just got along so well, Jake, you and I. There's no limit to what we can do. [Laughter.]

The CHAIRMAN. That's true. That's absolutely true.

Senator DODD. I think it's a Herculean task and I admire you for it. Your point was that if we can't do anything that we need a permanent moratorium bill. And while I admit I'm a cosponsor of it, I felt the effect of it there may be more to send a message, the fact that we introduced it, and that might slow down some overly aggressive activity. I think that effect is occurring.

I'll be honest with you. I'm a little uneasy about moratorium legislation generally. It seems to me we're delaying the inevitable. We've got to deal with this and the more we play games with the financial institutions and suggest that there are moratoriums always hanging around the corner, then the longer we delay in coming to terms with this problem. So I agree with the chairman and I'm willing to support it in the short term so that we don't have a runaway situation on our hands.

But I wonder if you, Mr. Kennedy, might comment on that since you did suggest—I think—a more permanent type of a moratorium and realistically, can we even anticipate—here we've found a very creative entity that turned around and saw—at least a violation of the spirit of title VI—and with all the work, we didn't anticipate that kind of a situation. At least I didn't.

I presume, no matter what we pass, somebody is sitting out there with a sharp pencil and figuring something that we haven't thought about and that's the way the marketplace works. No matter how tightly we try to write legislation around here, there's always going to be someone creative in that private sector that's going to figure out a way to get around it.

So I'm concerned about at least the suggestion of a permanent moratorium bill and would like you to comment on that if you will.

Mr. KENNEDY. Well, I hesitate to get in between the two Senators that are sitting at the table, but it was our feeling that in that the Congress was trying to change the structure of the financial institutions, which really hadn't been attempted for over 50 years, that perhaps there should be a delay until the Congress had ample time to consider all the facets.

What's happening now is, as I think Senator Dodd pointed out, the loopholes are being found by the smart lawyers in every corner and it may be that you'll have nothing to legislate pretty soon.

Senator DODD. That's right.

Mr. KENNEDY. My association supports a moratorium with a specified time duration to enable this committee to process sound public policy without having their deliberations constantly overtaken by events in the financial marketplace. During the moratorium the committee may wish to consider the consequences of financial services one-stop shopping from the perspective of conflicts of interest and the competitive and consumer implications.

Mr. MOSELEY. Senator, as far as I can see, I certainly would agree with the chairman that the permanent moratorium is destructive. We should certainly not rush into this question, but we should arrive at a conclusion. And just putting it off forever is not going to help anything.

Senator DODD. Does anybody else want to comment on that?

MORATORIUM WOULD BE A COPOUT

Mr. CARTER. I agree with that, Senator. A moratorium is somewhat of a weak word. In many ways it's a copout. We may have been desperate enough in this chaotic marketplace to take a weak word and in comparison become strong, but there's a real call for leadership and statesmanship on the part of the various commercial participants in the financial services industry and on the part of the Congress. If that can come together fast enough, then the moratorium isn't necessary—certainly a permanent moratorium isn't necessary. But it's uniform regulation of the financial services industry that we're striving for so hard.

Senator DODD. Well, I thank you and while my time has expired I just want to commend all of you. I think you've presented some excellent testimony this morning and raised some worthwhile points with regard to the differences, particularly in the risk area. I think that's an important point to make. So I thank the panel and I thank the Chairman.

The CHAIRMAN. Thank you, Senator.

Mr. Kennedy, let me just make one comment in response to what you said about Congress trying to change the structure. No, we are not. The marketplace is changing the structure rather dramatically and rapidly, and even if I thought I was intelligent enough to know how the future of the financial services industry should look like, it is not my political philosophy to try to impose that. I simply would not do that. I'm trying to get Congress, rather than being years and years behind the marketplace, to at least get up within a year or two so that we're plugging some of the loopholes. I don't want us out in front. We're not trying to change the structure at all.

My major problem is simply trying to get Congress to act. I would not oppose the moratorium if I had ever seen one instance where Congress during the period of moratorium had carefully considered the issues. But what happens is they impose the moratorium because the decisions are difficult to make, and then they think, "Aha, that's over," until the moratorium ends, and then at the end of the moratorium we're faced with another crisis or an extension of the moratorium. And it's usually the moratorium that gets extended, some of them for a couple of decades. Regulation Q was a temporary regulation that lasted for a long, long time.

And so that is the major reason that I am opposed to moratoriums. If somebody could guarantee me right now that during a 6-month moratorium we would do what we ought to do and at the end of that period we would have a bill that would pass and take care of it, I wouldn't object to a moratorium. But I have not one single example of where that has ever taken place, and a lot of these issues are not new. Many of them were being discussed before Chris and I even became Senators, let alone since I became chairman of the committee. We have had, since I've been chairman, probably 10,000 pages of testimony on these issues and I don't know how many hearings.

So I feel, whatever the decisions are, what I continue in each of the hearings to get people to agree is that we ought to move to a decision as quickly as we can, whatever the decisions are. I have no pride of authorship in specific provisions of the bill. A good part of the bill is designed to bring out the testimony and to enlighten us and educate us on what direction we should go to try and put a bill together, and that is my major objective, not to push a particular title of the bill or anything else, but to push Congress into making some decisions so that a moratorium and the thought of it isn't even necessary because if I were one of those players who had already gotten my fingers in the cookie jar, I would love a moratorium. I would think that would be great because it locks everybody else out and then you get into the issue of divestiture and that's a difficult one.

But in any event, we thank you very much for your patience and your willingness to testify today and I'm sure we will have additional requests for information from you. Thank you very much.

The committee is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

STATEMENT OF
MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY, CONNECTICUT MUTUAL LIFE INSURANCE COMPANY, AND PENN MUTUAL LIFE INSURANCE COMPANY
BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE

Massachusetts Mutual Life Insurance Company, Connecticut Mutual Life Insurance Company, and Penn Mutual Life Insurance Company appreciate the opportunity to comment on S. 2181, S. 2134, and S. 1609. Each of these bills would substantially deregulate banking, permitting bank holding companies to engage in commercial activities unrelated to banking. Two of the bills (S. 2181 and S. 1609) would specifically authorize banks to engage in insurance underwriting and brokerage, reversing the prohibition recently reaffirmed by Congress in the Garn-St Germain Depository Institutions Act of 1982.

These bills run counter to our historic national policy that banking should be separate from other forms of commerce. This policy was established over a century ago, but the reasons for it are especially valid today. They deserve the most thoughtful consideration in connection with the pending bills.

Banks perform a unique and critical role in our economy. They are the custodians of our savings. They provide our short-term credit. Our payments system works through banks, and they are the link between our monetary policy and our economy. Because they perform these unique functions, they are specially protected, and special limits have been imposed on their non-banking functions.

The basis for limiting banks' non-banking functions is solidly grounded in experience. Congress has consistently been concerned about the stability of banks and has sought to limit the exposure of banks to risk in fields unrelated to banking. This concern is especially relevant today when some of the nation's largest banks are beset with the most serious problems of shaky foreign loans. Congress has also been aware of the banks' role as impartial providers of credit and the enormous advantage that the ability to allocate credit carries with it in the world of commerce. The separation of banking and commerce has served well to limit the potential for abuse, and much of the testimony before this Committee has shown that this potential still exists.

Against the background of this strong national policy, those who would abandon it have indeed a heavy burden of persuasion. In that light, it is significant to note that the call for banks' entry into the insurance business does not come from the public. There is scarcely a suggestion of any public benefit in banks participating in insurance, and consumer and labor groups have soundly opposed that change in testimony before this Committee. The benefits from this aspect of deregulation would seem peculiarly limited to the handful of large money center banks that are its proponents.

A brief review of history and a summary of present conditions is illustrative. It demonstrates that the policy of restricting the insurance activities of banks should be continued in the public interest.

I. CONGRESS HAS FOUND IT IN THE PUBLIC INTEREST TO SEPARATE BANKING FROM COMMERCE AND FOR THE LAST 120 YEARS HAS LIMITED STRICTLY THE INSURANCE ACTIVITIES OF BANKS

Since it first provided for federal chartering of national banks, Congress has maintained the separation between banking and commerce. And as part of this policy, banking has, with minor exceptions, been separated from insurance continuously for 120 years.

Initially, the separation from insurance was implicitly provided in the National Bank Acts of 1863 and 1864, which limited the powers of national banks to "carry-[ing] on the business of banking" including the exercise of "incidental powers . . . necessary to carry on" such business.

(12 Stat. 665, 668 (1863); 13 Stat. 99, 101 (1864)). Insurance was not a power incidental to banking.

Although in 1916 a minor exception was made to this policy to permit national banks in certain sparsely populated areas to act as agents for the sale of insurance, the background to this limited exception shows no intent to change the basic policy of separation. The Comptroller of the Currency at the time emphasized the need to maintain otherwise the separation of banking from insurance and noted that the requested exception would not be "likely to trespass upon outside business naturally belonging to others." The Comptroller continued:

> "I think it would be unwise and therefore undesirable to confer this privilege [i.e., the ability to act as an insurance agent] generally upon banks in large cities where the legitimate business of banking affords ample scope for the energies of trained and expert bankers. I think it would be unfortunate if any movement should be made in the direction of placing the banks of the country in the category of department stores." (53 Cong. Rec. 11,001 (1916)).

On the basis of the Comptroller's views, this exception was added to a House-passed bill on the floor of the Senate, without hearings or debate.

After the adoption of the 1916 amendment, it was not until the Bank Holding Company Act in 1956 that Congress again focused on the separation between banking and insurance.

The 1956 Act, which resulted from long debate, limited the permissible insurance activities of bank holding companies and their subsidiaries to activities that are so closely related to the business of banking as to be incident thereto. Although the Bank Holding Company Act was amended in 1966 and again in 1970, these amendments continued to reaffirm the separation between banking and insurance.

Most recently, the Garn-St Germain Depository Institutions Act of 1982 included a Congressional declaration that most insurance activities are not closely related to banking and may not properly be engaged in by bank holding companies or their subsidiaries.

II. THE REASONS FOR THIS LONG-STANDING CONGRESSIONAL POLICY ARE EVEN MORE IMPORTANT IN LIGHT OF PRESENT DAY CONDITIONS

The bills pending before this Committee fairly call into question the basis for the policy that Congress has repeatedly reaffirmed. Are banks no longer unique? Can the affiliate structure effectively insulate banks from the risks of conducting unrelated businesses? Are banks really efficient in carrying out non-banking functions? Does the current condition of major banks suggest that the public interest would be served by their expanding into entirely new fields of non-banking activity? These issues are discussed in the following pages of this statement.

A. Banks' Unique Role in Our Economy Should Not Be Jeopardized by Non-Banking Activity

The policy that separates banks from commercial activities not closely related to banking recognizes the critical role of banks in our financial system. Banks, as Federal Reserve Board Chairman Paul Volcker has recently stated, are unique "as operators of the payments system, as custodians of the bulk of liquid savings, as unbiased suppliers of short-term credit, and as the link between monetary policy and the economy." (Testimony before this Committee, March 27, 1984, p. 1). Their role, as Chairman Volcker has acknowledged, demands continuing governmental oversight and "regulatory protection against undue risk or bias in the credit-decision process." (Testimony before this Committee, September 13, 1983, p. 6). This authoritative view suggests that the role of banks remains fundamentally unchanged and that the critical function of banks should not be jeopardized by permitting them to engage in non-banking activities.

B. Banks Cannot Be Separated From Their Affiliates

Even Chairman Volcker has recognized that banks "cannot be wholly insulated from the fortunes of their affiliates." (Testimony before this Committee, March 27, 1984, p. 2). Others share this view. The Federal Reserve Board's Division of Banking Supervision and Regulation, in considering the implementation of new capital guidelines in 1982, stated:

> "[I]t is the consolidated entity whose financial condition and strength will ultimately determine the fate of the bank subsidiary." (SR 82-17, March 17, 1982).

A recent study commissioned by the American Bankers Association acknowledges this point:

> "[I]n practice banks and bank holding companies would rarely want to 'walk away' from financial disasters that afflicted any of their affiliates. Rather, . . . they would deploy resources available from other members of the corporate family to prevent the failure of any other member." (American Bankers Association, Testimony before this Committee, February 22, 1984, Attachment 1 at p. 13).

These views are persuasive that, as a practical matter, the fortunes of banks are tied to their affiliates. If a bank cannot effectively be insulated from the business failure of an affiliate, then the Congress should examine the activity of the affiliate as if it were the activity of the bank itself.

C. Bank Holding Company Affiliates Have Performed Poorly in Non-Banking Activities

There is skepticism about the ability of bank holding companies to carry on non-banking activities efficiently. The doubts are based upon empirical studies, which are described in the recent American Bankers Association study:

> "A number of studies have attempted to evaluate the performance of bank holding company subsidiaries relative to that of other firms in the same lines of business. They generally conclude that the performance of bank holding company subsidiaries is inferior to that of firms not affiliated with banks." (Id., pp. 24-25).

The bank subsidiaries studied included those engaged in consumer finance, mortgage banking, and equipment leasing. Each study concluded that these activities were less profitable and riskier when undertaken by bank holding company subsidiaries than when undertaken by independently owned firms. The studies suggest little or no consumer benefit from bank holding company participation in these businesses. As the study of finance company affiliates of bank holding companies stated:

> "It must be concluded that this study does not confirm the arguments of BHC's that their entry into the consumer finance industry will yield numerous public benefits. To the contrary, results indicate poorer performance by affiliates with respect to profits, leverage, and interest expenses." (Rhoades & Boczar, "The Performance of Bank Holding Company-Affiliated Finance Companies," Staff

Economic Studies of the Board of Governors
of the Federal Reserve System, 1977, p. 19).

The poor performance of bank holding companies in these endeavors raises doubt that there would be any public or consumer benefits from the entry of bank holding companies into other fields. These activities--consumer finance, mortgage banking, and equipment leasing--are closely related to banking. If banks could not perform them competitively, it is highly unlikely that they could do better in activities--such as insurance underwriting and brokerage--to which they bring little or no experience or expertise.

D. The Banking Industry Is Currently Under Extreme Pressure, and Many Large, Important Banks Are in a Strained Financial Condition

It is also important to recognize that the banking industry has its hand full with its present responsibilities. More than four percent of the banks insured by the FDIC are on its problem bank list, and another nine percent "exhibit a combination of financial, operational or compliance weaknesses ranking from moderately severe to unsatisfactory." (American Banker, January 6, 1984).

The banks' difficulties stem largely from problem loans. Many of the nation's largest banks hold substantial amounts of non-performing real estate and energy loans. In several cases, the amount of non-performing loans exceeds the bank's capital, and some believe the amount of their exposure may be understated. (Wall Street Journal, March 19, 1984).

The extent of this exposure, however, pales in comparison to the banking industry's exposure on loans to developing nations. Indeed, had an accommodation not been reached with Argentina last month, its nonpayment of interest (which was already almost three months overdue) would have caused the money center banks to report billions of dollars in losses. Of the thirteen largest banks, twelve have loans that exceed their capital outstanding to Argentina, Brazil, Mexico, Venezuela, and Chile. The thirteenth has loans to these five countries that exceed four-fifths of its capital. These five debtor countries have had difficulty in meeting their obligations and have routinely sought concessions from the banks. In 1982-83, each of them disrupted its debt service. (Cline, "International Debt and the Stability of the World Economy," Institute for International Economics, September 1983, pp. 34, 35.)

These statistics, of course, do not include the banks' exposure on loans to other developing nations. While not as serious as the problem in the Americas, as noted by Secretary Regan in his March 28, 1984, appearance before this Committee, loans to other developing nations have also been subject to difficulties.

In sum, the current condition of some major banks--including several of the leading proponents of expanded bank powers--suggests that this is no time to sweep away the law that has confined banks to banking and a particularly inappropriate time to authorize new non-banking activities in which banks have little or no experience.

III. INSURANCE UNDERWRITING AND SALES MAY BE THE LEAST APPROPRIATE OF THE ADDITIONAL BANK POWERS UNDER CONSIDERATION

None of the non-banking enterprises that the various bills would authorize is risk-free--especially if, as past history suggests, they are likely to be less efficiently operated by bank holding company affiliates than by others. This is particularly true of insurance underwriting. In a study commissioned by the American Bankers Association, Arthur Young & Co. concluded that bank entry into insurance underwriting would not be desirable:

> "Insurance underwriting is a low profitability, high risk, high critical mass, skill intensive, cyclical, non-growth market. It is not an attractive market to enter. . . .
>
> "Banks are not well positioned to enter the business, as they lack the expertise, knowledge, and product synergism. It may negatively affect their image. It appears that banks' competitive advantages will not be capitalized upon in this service market. . . ." (Assessment of Business Expansion Opportunities for Banking, February 1983, p. 36).

With their own experts advising them that they have so much going against them in the insurance underwriting field, the nation's largest banks still seek this authority. But this Committee must consider the public interest as well as the ability of the banks to succeed in this uncharted territory, in which they "lack the expertise, knowledge, . . . product synergism . . . [, and] competitive advantages." When it does so, this Committee must conclude that the public interest would not be served by putting banks into businesses they do not know.

Nor is insurance agency authority without risk. The insurance business has become specialized and more complex in recent years with a continuous emphasis on new products. Life insurance agencies now sell an ever expanding number of such new policies of which universal life, variable life, and single premium deferred annuities are examples. Because the public often relies on the agency's choice of an underwriter for these products, the agency may feel obliged to make up its customers' losses for business reasons, even if it would not be legally bound to do so. Presumably, it was this concern which prompted Merrill-Lynch, in the last quarter of 1983, to incur an $88 million charge against income to assure that those of its customers who purchased single premium deferred annuities from a Baldwin-United subsidiary would receive the benefits for which they contracted. And other companies that sold such annuitites have arranged to assume similar losses.

IV. THERE IS NO PUBLIC INTEREST IN BANKS HAVING INSURANCE POWERS; IN FACT, CONSUMER GROUPS OPPOSE THIS MEASURE AS CONTRARY TO THE PUBLIC INTEREST

The call for expanded bank powers is actually narrowly-based special interest legislation. There is no significant public demand for "one-stop" financial services. The entry of banks into the insurance business would benefit only a few large money center banks.

A. Surveys of Consumers

This lack of public demand is illustrated by a recent poll by Fortune, which found that 57 percent of those surveyed agreed that there "don't seem to be many benefits in using one source for most of my financial services." (Fortune, The New World of Personal Financial Services (1983)). A similar survey by Money found that only 34 percent preferred buying financial services from a multiservice company. Even the financial conglomerates recognize that most consumers are not seeking one-stop shopping. A senior vice president of American Express was recently quoted as saying, "Our studies have suggested that consumers are not anxious to deal with one firm for all of their financial services." (National Journal, March 17, 1984, p. 506).

B. Opposition by Consumer Representatives

The consumer representatives who have testified before this Committee have strongly opposed the expansion of powers to enable banks to enter into insurance and other fields of commerce. The Consumer Federation of America, citing "concerns over excessive economic power," has called for a delay in authorizing expanded activities by banks. (Testimony before this Committee, February 29, 1984). The concerns of the Federation are appropriate. The ten largest banks in the United States have more than $610 billion in deposits and trust assets--an amount greater than the total assets of the entire life insurance industry. The American Association of Retired Persons has also opposed the pending legislation. AARP commented, "It seems a strange time to invite commercial banks to expand their operations into new fields," noting that the largest banks have foreign loans that exceed their capital. (Testimony before this Committee, February 29, 1984).

The National Federation of Independent Business opposes the bills on the basis of a poll to its small business members, 61 percent of whom oppose bank deregulation. NFIB's members are concerned about the diversion of funds away from commercial lending and the potential for tying other services to their loans. (Testimony before this Committee, March 7, 1984.)

The concern about tying is generally shared by consumer groups. Indeed, except for the proponents of these bills, there seems to be a consensus that tying cannot be prevented or adequately policed, no matter what prohibitions are included in legislation or regulation. The subtleties of the credit origination process virtually assure that tying will occur and go undetected. Tying the grant of credit to the purchase of insurance products will be a natural consequence of deregulation, despite every effort to legislate against it.

Some consumer advocates have also recognized that granting banks insurance agency powers could be anticompetitive. The banks' control of the availability of credit gives banks a powerful advantage over insurance agents that could eliminate these agents as a substantial competitive force in the market. One of the strongest statements against the pending legislation was made by the AFL-CIO. Noting the hazards of tie-in sales and the adverse impact on insurance agents, the AFL-CIO said:

> "Expansion of banks into the insurance field would further the concentration of economic power and reduce the bargaining power of consumers. The AFL-CIO is strongly opposed to the proposed permission for bank holding company affiliates to engage in insurance underwriting and sales." (Testimony before this Committee, March 7, 1984).

Thus, consumer and public interest witnesses before this Committee were overwhelmingly opposed to the extension of banks into other areas of commerce, including insurance. This testimony confirms the various public opinion surveys that have found little interest in "one-stop" financial services.

V. THE PENDING PROPOSALS WOULD NOT PROVIDE A "LEVEL PLAYING FIELD"

If Congress is seeking to provide a level playing field by permitting banks to engage in insurance and insurance companies to engage in banking, the resulting legislation should address the unique organizational restraints confronting mutual life insurance companies. In the interests of fairness, deregulatory legislation should permit all insurance companies to compete on the same basis as banks and other financial institutions. The current proposals fail in both respects.

A. Pending Bills Would Disadvantage Mutual Life Insurance Companies Seeking to Participate in Banking

Both S. 1609 and S. 2181 contemplate an upstream holding company providing diverse financial services through downstream subsidiaries. This structure, however, is not available to a mutual life insurance company which, as a result of its mutual status, is unable to form an upstream holding company. Thus, the only way it might avail itself of the structure contemplated by the proposals would be to convert to a stock company. Such a conversion, however, is currently prohibited by the laws of many states. Therefore, conversion to stock status is not an alternative readily available to mutual life insurance companies. And this is apart from the vast amount of financing that would be required to effect a conversion were this option otherwise available.

Note also that it would be impossible for a mutual insurance company to own a bank subsidiary directly. Such ownership would require the insurer to comply with the Bank Holding Company Act. This in turn would require the liquidation of the substantial real estate and stock portfolios which support the mutual company's insurance business.
S. 2181 attempts to remedy this problem by authorizing the formation of consumer banks, which could be owned without compliance with the Bank Holding Company Act. But consumer banks would have limited powers that would prevent them from competing effectively on the same basis as traditional banks.

If Congress pursues deregulation, it must take into account the unique problem of mutual insurance companies. Legislation that puts mutual insurance companies at a special disadvantage would not provide the level playing field often cited as an objective of this legislation.

B. The Proposals Would Disadvantage Many Life Insurance Companies Seeking to Engage in Banking

A second major concern in achieving a level playing field is the need to eliminate impediments under state law to a life insurance company's entry into the banking business. Although the proposals appear to preempt inconsistent state statutes that would otherwise bar a national banking association from affiliating with a life insurance company, these provisions do not appear broad enough to permit in all cases the formation or acquisition of a national banking association by a life insurance company. (See S. 2181, § 104(h); S. 2134, § 7; S. 1609, § 14.)

Thus, in order for the proposals to provide a level playing field, these provisions should be examined and amended to assure that they eliminate all barriers to fair competition.

VI. LEGISLATION TO DEAL WITH THE ACTUAL REGULATORY PROBLEM AREAS IS DESIRABLE

Although we oppose sweeping deregulation of banking, we recognize that there are regulatory problems that should be addressed. We would endorse legislation dealing with these problems.

Such legislation should close the "non-bank bank" loophole. Non-bank banks should be treated as banks, subject to the Bank Holding Company Act with no grandfathering provided. As a result, the Bank Holding Company Act would require the divestiture either of the former non-bank bank or of the entities engaged in unauthorized commerce. There is precedent for divestiture. When the Bank Holding Company Act was amended in 1970 to apply to one-bank holding companies, almost 400 non-bank financial institutions were required to divest their bank subsidiaries. At this time, only about 60 institutions would be affected. (See Volcker, Testimony before this Committee, March 27, 1984, Appendix A).

This legislation should also close the so-called "South Dakota loophole," so named as a result of South Dakota's having enacted legislation to permit state-chartered banks to engage in insurance activities in all states other than South Dakota. This legislation was intended to meet the needs of Citicorp, which acquired a South Dakota-chartered bank and attempted to enter the insurance business via the new legislation. The Federal Reserve Board, however, has decided not to act on Citicorp's application to use its South Dakota bank subsidiary in this fashion, noting that the issue was pending before Congress.

S. 2134 addresses the South Dakota loophole by limiting the permissible activities of state-chartered depository institutions to those permitted by the Bank Holding Company Act or those authorized by state statute or interpretation prior to January 1, 1983. In addition, the bill precludes any state from authorizing state-chartered depository institutions to engage in insurance activities out-of-state.

Finally, consideration should be given to federal legislation limiting the ability of state-chartered banks and depository institutions to engage in commerce. Under current law, if certain state-chartered banks or depository institutions are not federally regulated, there is no federal impediment to their engaging in commercial activities. The recent recommendations of the Temporary State Commission on Banking, Insurance and Financial Services in New York suggest that unless the federal government acts, states will soon be competing to provide the most favorable regulatory climate for banks. As Chairman Volcker has indicated on several occasions, this competition could undermine national banking policy and damage the nation's financial and economic health.

CONCLUSION

The deregulatory proposals now before the Committee would inappropriately permit banks to engage in commercial activities. This extension of powers would be contrary to sound long-standing national policy separating banking from other areas of commerce.

No showing of need has been made by the proponents of this legislation. Few consumers are seeking an extension of bank powers, and all indications are that an extension would fail to benefit them.

Although we oppose the various comprehensive deregulatory proposals, we do support legislation to remedy key regulatory problems, including those posed by the "non-bank banks."

MORTGAGE INSURANCE COMPANIES OF AMERICA
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April 13, 1984

STEVEN P. DOEHLER
EXECUTIVE VICE PRESIDENT

The Honorable Jake Garn, Chairman
Banking, Housing and Urban Affairs
Room SD 534, Senate Dirksen Building
Washington, DC 20510

Dear Chairman Garn:

The Mortgage Insurance Companies of America (MICA)* appreciates this opportunity to comment on S.2181 and S.2134. Both S.2181 and S.2134 generally seek competitive equity by allowing financial institution holding companies to expand into new financial services. The expansion into the field of the mortgage insurance industry apparently authorized by S.2181 raises significant concerns for safeguards to prevent conflicts of interest and unsafe and unsound practices. If mortgage insurance companies (MICs) in the future do not operate with such safeguards this is likely to substantially damage the public interest and the financial integrity of the mortgage insurance industry.

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* MICA consists of thirteen domestic private mortgage insurance companies whose insurance-in-force on December 31, 1983 was approximately $148 billion. The national officers are Leon T. Kendall (Chairman of the Board of Mortgage Guaranty Insurance Corporation), Milwaukee, Wisconsin, President; William A. Simpson (President of Republic Mortgage Insurance Company), Winston-Salem, North Carolina, Vice President; Claude E. Pope (President of General Electric Mortgage Insurance Companies), Raleigh, North Carolina, Secretary/Treasurer; and Steven P. Doehler, Executive Vice President, Washington, DC.

☐ COMMONWEALTH MORTGAGE ASSURANCE COMPANY ☐ FOREMOST GUARANTY CORPORATION ☐ GENERAL ELECTRIC MORTGAGE INSURANCE COMPANIES ☐ HOME GUARANTY INSURANCE CORPORATION ☐ INTEGON MORTGAGE GUARANTY CORPORATION ☐ INVESTORS MORTGAGE INSURANCE COMPANY ☐ MORTGAGE GUARANTY INSURANCE CORPORATION ☐ THE MORTGAGE INSURANCE COMPANY OF CANADA ☐ PMI MORTGAGE INSURANCE CO. ☐ PAMICO MORTGAGE INSURANCE COMPANY ☐ REPUBLIC MORTGAGE INSURANCE COMPANY ☐ TICOR MORTGAGE INSURANCE COMPANY ☐ UNITED GUARANTY CORPORATION ☐ VEREX ASSURANCE, INC.

MICA believes there are a number of reasons as to why its views are unique to financial services deregulation. First, our industry actually experienced a tragic collapse the last time ownership of insurers by lenders or their holding companies was permitted. As a result, when the modern industry was rebuilt in the late 1950's and early 60's new operating safeguards were established such as the monoline insurance requirement and the conservative reserving structure that protects against catastrophic loss. Secondly, the ownership structures within our industry are varied. The companies structure safeguards into their business practices when dealing with their parent companies or affiliates. Third, the role of mortgage insurance is changing due to the expansion of the secondary mortgage market. More lenders are originating loans for sale to investors in the secondary market and relying on mortgage insurance as protection. Uncompromised quality of mortgage collateral is a growing investor concern. Fourth, the mortgage insurance industry's perspective on risk coincides with that of the consumer entering into a mortgage financing arrangement while it offsets risk for the lender. This alliance of interest between mortgage insurers and consumers in evaluating the viability of mortgage loan arrangements of lenders is an essential consumer protection, given the recent desire of lenders to shift interest rate risk to the borrower by utilizing adjustable rate mortgages.

Background

With the non-traditional financing available in today's residential mortgage market it is far more dangerous than ever before for lenders and mortgage insurers to be operating with the potential for conflicts of interest. Mortgage insurers indemnify mortgage lenders against default on conventional first mortgage loans on owner occupied single family residences. The concept of mortgage insurance is based upon a system for estimating expected loss from mortgage defaults and for estimating the needed reserves to meet such loss. There are two potential areas of loss for which MICs are at risk. One area is determined by how well the borrower's financial characteristics match the terms and conditions of the mortgage. The other area of risk relates to the value of the underlying mortgage property. The type of default risk for which MICs reserve must be calculated not only on the basis of a typical economic environment but also on the basis of economic decline or even catastrophe. The hazard we insure against can be greatly influenced by the vigor or lack thereof of the national or regional economy. Any potential for tie-ins or unsafe business practices skews the ability of the insurer to be adequately protected against catastrophic loss.

MICA supports deregulation and welcomes increased competition into our already very competitive industry. However, we believe that in order to have deregulation of financial services including mortgage insurance, it is critical that there be a sufficient level of financial discipline present in the marketplace for that service. Financial discipline, a strict risk to return analysis made by each party to the transaction, can help to remove conflicts of interest, fraud, mismanagement and other abuses with which regulations have been established to deal. Financial discipline also is essential to promote true competitive equity that will serve the consumer.

Mortgage insurance is sold to the mortgage lender and is distinct from many insurance products affected by the proposed legislation which are sold directly to the consumer. The sharing of risk between lenders and insurers has been demonstrated to work best when mortgage insurers and their lender customers deal on an "arm's length" basis. We urge this Committee, as it deliberates legislation that would allow bank and savings and loan holding companies to underwrite or broker insurance, to evaluate the need for prudent safeguards that maintain operational integrity as well as competitive equity.

A Historical Warning For Today

This Committee should pay particular attention to past history in its consideration to allow expansion by savings and loan and bank holding companies into the mortgage insurance industry. The initial mortgage insurance industry evolved out of the title insurance business, beginning in 1911 when many insurers were bank affiliated. The most active were located in New York. By 1930, there were 50 New York based mortgage insurance companies with aggregate capital and surplus of $204 million, underwriting approximately $2.8 billion of mortgage insurance as of year end 1930.

The private mortgage insurance business collapsed in the 1930's as a result of poor underwriting practices attributable to lack of adequate regulations and conflicts of interest between lenders and their affiliated insurers. A complete and authoritative source of this early history of mortgage insurance can be found in the exhaustive Report to the Governor of the State of New York, issued in 1934 by the Alger Commission. This Commission was created as a result of the collapse of the mortgage insurance industry and was asked to examine the resulting financial chaos, including the tremendous losses to lenders, depositors and investors. The Commission recommended legislation requiring the separation of the mortgage insurance companies from the banking institutions. The Commission's Report viewed the combination of the lender and the insurer as a major reason, if not the major reason, for the collapse of the industry. In fact, the Alger Committee's report concluded, in part, that:

> "the business of guaranteeing mortgages is not an ordinary banking function, and the public would have been better off if none of the (insurance) companies had owned or been affiliated with banking institutions, or in turn had not been owned by them."

(emphasis supplied).

The reason why the industry collapsed in the 1930's is that although a serious potential for conflict of interest existed where a mortgage insurance company was owned by a bank, there were no statutory or regulatory safeguards establishing reserves or preventing abuses and requiring independent operation of the mortgage insurance companies.

Conflict of Interest

The term "conflict of interest" describes a situation in which regard for one duty tends to lead to disregard of another. In the mortgage insurance business a conflict of interest can occur when mortgage insurance is provided without adequate assessment of the risk on the mortgage instrument. An example would be to provide mortgage insurance on a loan with such a high risk it would be uninsurable but the loan is not rejected because the lender's desire for the fee income available in the origination process overrides the default concern.

Private mortgage insurers provide protection for lenders against homeowners defaulting on their mortgages. In order to provide this protection MICs must be unbiased in their evaluation of each lender for financial soundness and prudent lending practices before issuing a master policy agreeing to insure mortgages originated by the lender. In addition, mortgages originated by the lender must be objectively evaluated by the MIC before insurance is provided. Finally, when a lender files a claim, the impartial decision on how to best settle a claim must be based exclusively on what is in the best interest of the MIC.

Experience has demonstrated it is far easier to maintain the objectivity necessary for guaranteeing successful third-party underwriting and claims handling if the lender and MIC deal with each other at arm's length. Objectivity can become more difficult to maintain if an insurer deals with a parent financial institution holding company or a lender affiliate of the holding company system.

This potential conflict of interest when lenders apply for insurance from captive mortgage insurers was noted in an extensive report written by Arthur D. Little, Inc. (ADL) in 1975 for the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA). Because the charters of these federal secondary market agencies contain legislated requirements for private mortgage insurance on the high ratio loans they purchase, the soundness of our industry is of utmost importance to the financial health of FHLMC and FNMA. Addressing itself to the then pending proposals for the bank holding companies to engage in the mortgage insurance business, the ADL report to the secondary agencies states:

> "We would view with some alarm any significant entry into mortgage insurance by bank holding companies primarily owing to the potential threat to solvency raised by the inherent conflicts of interest in any lender-controlled insurance operation. . ."

Arthur D. Little, Inc., The Private Mortgage Insurance Industry, 138, (April 1975).

Dr. Chester Rapkin, Professor of Urban Planning, Princeton University, also noted the necessity for arm's length dealing between insurer and insured in his analysis of private mortgage insurance:

> As long as revenue continues to exceed losses with the enlargement of the mortgage market, however, mortgage insurance is beneficial both to the lender and to the family whose mortgage application might fall just short of acceptance without it. Conversely, there is always the danger that under these circumstances the lender will make loans as long as there is an opportunity to increase income, even in the face of a disproportionate rise in risk. There are several important safeguards against this

> contingency. One safeguard is the separation of the insurance and lending functions, placing each in independent institutions that deal with each other at arm's length.

C. Rapkin, Private Mortgage Insurance, reprinted in M. Seldin, The Real Estate Handbook 730, 731 (1980).

A final consideration as to the potential for conflict of interest in an ownership relationship between a MIC and a lender concerns the actual need for mortgage insurance. Because a mortgage insurer can be a source of income for a financial holding company, there is the possibility that the lender's determination of the necessity of mortgage insurance may not be made objectively on the evaluation of risk but upon the potential profit to the lender. When lenders deal with MICs at arm's length the competition among lenders typically results in a lender decision to require mortgage insurance on the basis of reducing the lending risk. Arm's length competition and the resulting discipline from the market, assures that the process will not result in the risk of unnecessary mortgage insurance.

Conclusion

MICA supported the recently enacted Title VI of the Garn-St Germain Depository Institutions Act of 1982 and we do not recommend that this Committee abandon the established barriers between insurance and banking. */ However, if this Committee vors adoption of legislation to permit bank and savings and holding companies expanded powers, including the ability to se nd underwrite mortgage insurance, MICA believes that the Committee should recognize the historical precedent and the serious potential for conflict of interest problems presented in lender affiliation with mortgage insurance companies. Continued market discipline and business safeguards are essential for mortgage insurance to fulfill its expanding role in mortgage finance.

In order to assure that conflicts of interest are avoided and that a particular MIC does not profit at the expense of its affiliated (and often FSLIC or FDIC insured) lender (or visa versa), MICA believes that, at a minimum, there should be a provision in the legislation requiring that a MIC insure loans

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*/ FSLIC insurance regulations prohibit a savings and loan affiliate from doing business with a mortgage insurance company affiliate. See 12 C.F.R. 563.44 (1983). Comparable banking regulations have not been needed because mortgage insurance has not been permitted under Section 4(c)(8) of the Bank Holding Company Act, 12 U.S.C. 1843(c)(8) (Supp. 1983). If the FSLIC restrictions continue to exist while bank holding companies are permitted to own mortgage insurers, MICA believes that to assure competitive equity an identical restriction should apply to dealings between banks and their affiliate mortgage insurers.

for its affiliated lender only if they are underwritten on the same basis, for the same consideration and subject to the same insurability requirements as insurance provided to nonaffiliated lenders.

Thank you for the opportunity to present MICA's views on expanded powers for bank and savings and loan holding companies. We look forward to working with the Committee as the legislative process determines what the expanded powers will be.

Sincerely,

Steven P. Doehler

SPD/mbg

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May 2, 1984

The Honorable Jake Garn, Chairman
Senate Committee on Banking,
Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D. C. 20510

Re: S.2181 Financial Services Competitive Equity Act

Dear Mr. Chairman:

This letter is being written on behalf of the members of Insurance/Financial Affiliates of America, Inc., members who are financial institutions or insurance organizations who have a common interest in the marketing of insurance related to financial institutions.

This organization supports the bank deregulation objectives of S.2181, but we believe certain provisions need attention. I/FAA is, however, apprehensive that in the legislative process some of the benefits accrued from Title VI of the Garn-St Germain Depository Institutions Act of 1982 may be impaired. Also there are provisions in section 107 of S.2181 which we believe should be amended to satisfy a more balanced perspective toward the competitive and public benefits accruing from the ability of banks and other lenders to offer insurance on an equitable basis to their borrowing customers. In terms of concrete recommendations, Insurance/Financial Affiliates of America, Inc. supports the proposed language changes attached and will appreciate consideration by you and the Committee.

There is another area of interest. For many years the Bank Holding Company Act of 1956 has permitted subsidiary underwriting of credit life and disability insurance, either direct or as a reinsurer. It seems reasonable to specifically authorize such companies to reinsure credit life and disability coverages for primary underwriters who offer the same coverage for their borrowers. S.2181 is the ideal vehicle for this if the insurance powers now in S.2181 do not survive.

Thanks for developing S.2181 as a competitive aid.

Sincerely,

A. F. Rossberg
President

ch

Enclosures

May 2, 1984

PROPOSED AMENDMENTS TO S.2181
FINANCIAL SERVICES COMPETITIVE EQUITY ACT

(Additions underscored; deletions in brackets [])

TITLE I, SECTION 104

1. Amend Par. (8)(B)(vi), lines 12 through 17 (page 17), to read as follows:

> ing or of a financial nature. The Board may by regulation prescribe limitations on the conduct of any activity or activities authorized under paragraphs (8), (15), and (16) of this subsection consistent with the criteria in subparagraph (b)(iv) hereof and with safe and sound financial practices[.], except that no limitation may be prescribed that would impair, diminish, or restrict insurance activities permitted under Title VI of the Garn-St Germain Depository Institutions Act of 1982 (P.L. 97-320, 96 STAT. 1469) as it amended section 4(c)(8) of the Bank Holding Company Act or under subsequent regulations promulgated by the Board thereunder. In administering this paragraph, the

(COMMENT: The purpose of this amendment is to assure continuity of insurance activities which have already been undertaken under section 4(c)(8) after passage of the Bank Holding Company Act of 1956, including those granted as a consequence of the 1970 amendments and Title VI of the Garn-St Germain Depository Institutions of 1982. The concept of permitting the Board to "prescribe limitations" on new and broader activities authorized in a bank deregulation measure may be sound enough, but no business activity in existence prior to passage of a new measure should be subjected to regulatory limitations not initially imposed by the legislation.

2. Amend lines 21 through 25 (page 17) to read as follows:

"(vii) The regulation required under clause (vi) of this paragraph shall include any activity determined by the Board by regulation prior to the enactment of this Act to be so closely related to banking or managing or controlling banks as to be a proper incident thereto[.], including permissible insurance activities prescribed in Title VI of the Garn-St Germain Depository Institutions Act of 1982 (P.L. 97-320, 96 STAT. 1469). The

(COMMENT: The primary purpose of this proposed amendment is to bring this "grandfather clause" language into harmony with the language change suggested in Item 1 preceding, but there is another specific reason. Prior to Garn-St Germain, insurance activities following the 1970 amendments to the Bank Holding Company Act were permitted on the basis of Board determination that the insurance activities were "so closely related to banking or managing or controlling banks as to be a proper incident thereto." When Congress passed

Title VI, one purpose of which was to impair the growth of some bank holding company activities, Congress prescribed seven exempted activities which thereby became so closely related to banking as to be a proper incident thereto. It is imperative that the language of S.2181 does not unwittingly supply a vehicle by which the Board might ignore the action of Congress under Garn-St Germain, as those activities were determined by Congress and do not fall within the purview of activities to be "determined by the Board by regulation." The above addition to the language would therefore embrace the language of Title VI and the statute in these grandfather provisions.)

TITLE I, SECTION 107

3. Amend lines 17 and 18 (page 32) to read as follows:

AMENDMENTS TO [BANK HOLDING COMPANY ACT]
TRUTH IN LENDING ACT
[AMENDMENTS OF 1970]

(COMMENT: It is difficult to support the discriminatory effects of section 107 in terms of adding new lending requirements of bank holding companies who engage in ancillary insurance activities, and then ignore a host of other kinds of lending institutions. Among these are savings and loan associations, finance companies, mortgage loan companies, state banks, credit unions, and other financial institutions not owned by bank holding companies who would not be covered under the proposed requirements. A far more reasonable approach is to place the amendments in the Truth in Lending Act in order to embrace a significant majority of affiliated lending and insurance activities.)

4. Amend lines 19 through 24 (page 32) to omit language indicated as follows, and add appropriate portions of the Truth in Lending Act:)

Sec. 107. [Section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1971 et seq.) is amended--

(1) by redesignating subsections (c) through (h) as subsections (d) through (i), respectively; and

(2) by inserting after subsection (b) the following:]

(APPROPRIATE TRUTH IN LENDING ACT
REFERENCES TO BE SUBSTITUTED)

(COMMENT: This is simply to modify the references to the statutory provisions of the Truth and Lending Act.)

5. Amend line 25 (page 32) to read as follows:

"(c) A [bank] covered creditor shall--

(COMMENT: This will change the reference of a bank to cover all creditors embraced by the Truth and Lending Act.)

6. Amend lines 1 through 7 (page 33) to read as follows:

"(1) explain in writing to a person who solicits credit with reference to which insurance is or may be required that such insurance may be purchased from an insurer or agent of such person's choice[, and shall not directly or indirectly solicit such insurance until it has given such person a commitment in writing that the credit solicited shall be extended];

(COMMENT: The language proposed to be omitted borders on being violative of constitutional guarantees of due process. The argument advanced by opponents of insurance activity by lending institutions is that borrowers will be compelled "in their minds" to purchase the insurance in advance in order, "in their minds," to enhance chances of receiving favorable action on their loan applications. Even if the allegations had some foundation in fact, there is no need for this language in view of the later provisions which guarantee a free examination period of 30 days. This latter provision subordinates any other inhibition needed to refute claims of possible direct or indirect tying or attempted tying. Moreover, the conditions in the language proposed to be removed place a bank (or other covered creditor) at a severe competitive disadvantage if the subject of insurance or potential availability of it could not even be mentioned "indirectly" before a loan commitment is made.)

7. Amend lines 22 through 25 (page 33) and lines 1 through 3 (page 34), to read as follows:

[bank] covered creditor

"(3) not use or disclose, without the prior written consent of the borrower, mortgagor, or purchaser [obtained at a time other than the making of the loan or extension of credit,] information relative to renewal or expiration of a contract of insurance which is required by the credit transation, for the purpose of replacing such insurance;

(COMMENT: The language proposed to be omitted imposes unreasonable requirements as indicated in the prior item. The added words, "renewal or expiration of," act to limit the restriction to information on the effective date or expiration of the insurance. Other areas of the insurance policy which are not sensitive to competitive solicitation do not need a restriction on insurance services that may be provided by the bank (or other creditor).

8. Amend lines 4 through 9 (page 34) to read as follows:

"(4)(A) accept, with regard to any insurance issued or sold by it or an affiliate thereof, and any insurance agent, broker, or company providing insurance connected with the extension of credit by any covered creditor shall accept, in connection with an extension of credit made by such [bank] covered creditor, the cancellation by a borrower of any such insurance if notified by the borrower within [30] 15 days of the effective date of the insurance, and an acceptable substitute policy has been filed with the lender[;] and

(COMMENT: The cancellation provisions should apply to every insurance policy issued in conection with an extension of credit, regardless of whether the agent or company is affiliated or unaffiliated with the bank or creditor. The identification "bank" is removed in favor of the broader definition of all creditors covered under the Truth and Lending Act as previously proposed. The 30 day "free examination" period is recommended to be changed to 15 days in order to (1) prioritize a necessity for action by the borrower(s) so that there will be no inclination to fail to cancel by default (certain consumer groups have urged the change to 15 days for this reason); and (2) because of the practical difficulties attached to a 30 day free cancellation when it may not be neccessary to accomplish the objectives of this paragraph. Such a long period may create an unnecessary work load in the handling and processing of loan documents, payment programs, computer services, and other ancillary efforts. Moreover, this provision is a direct impingement on McCarran-Ferguson Act and principles of state regulation of insurance.

There are also underwriting considerations of import attached to the providing of "free" insurance for either a 15 day or 30 day period. Claims will arise under policies which would otherwise have been cancelled, and the loss ratio on that particular part of the business will suffer severely at the averaged-out expense of other insurance buyers whose policies provide the book of business for any given insurance underwriter.

The additional language regarding a substitute policy seems to be essential so a lender is not placed in the untenable position of having to cancel a policy issued through an affiliated insurance subsidiary, but without a replacement policy, and then carry a loan made on collateral that is uninsured against physical loss. A bank could well be in violation of regulations if it permitted, for example, a mortgage loan is granted, the insurance policy is cancelled within 15 or 30 days after the loan, and no replacement or substitute policy is on file to protect the bank's interest in the collateral.)

9. Amend lines 10 through 23 (page 34) and omit lines 14 through 23 (page 34), subparagraph (B)(3) and paragraph (i) entirely, as follows:

"(B) refund the unearned portion of the premium to the creditor within twenty days after receipt of a notice of cancellation if no liability for a loss under the insurance has been incurred." [; and]

[(3) by adding at the end of subsection (b)(2) the following:

"(I) Any action for injunctive relief that may be commenced by any person pursuant to subsection (g) may be commenced on behalf of such person by any trade association for which such person is a member. Any such action commenced by a trade association shall be subject to the same requirements, limitations, and conditions as would be applicable had such action been commenced by any such person pursuant to subsection (g).".]

(COMMENT: There is one area of insurance not specifically dealt with in these provisions, but would fall within this subparagraph (B) if applicable. There are some classes of property which are such high risk because of volatile circumstances unique to that particular property that insurance cannot be purchased through normal channels, and such properties must be insured through surplus lines underwriting sources. These policies are usually guaranteed on the basis that the premium is due upon binding of the coverage, an no cancelation is permitted without an earned premium charge. Policies issued in Lloyds of London are a good example of this procedure made necessary because of the complex process of negotiating placement of the risk at the time it is ordered in the London market.

The purpose of omission of the semicolon and the word "and" preceding subparagraph (3) is to provide for the omission of subparagraph (i) in its entirety. There is no reasonable basis, if there is a legal precedent at all, for statutorily extending the individual rights of a person or organization to a "trade association for which such person is a member." There are surely other methods by which a trade association can participate, if necessary, in "watch-dogging" the interests of its members without attempting to subordinate the rights of an indivual to a trade association. Whether or not the consent of the individual member exists, this language should be stricken as having no place in federal law.)

NORWEST CORPORATION

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Statement By Norwest Corporation Concerning Reinsurance Activities of Bank Holding Companies

This statement is submitted by Norwest Corporation to the U. S. Senate Committee on Banking, Housing & Urban Affairs for inclusion in the record of hearings held on the subject of Competitive Equity In The Financial Services Industry.

Historical Background

Norwest Corporation is a diversified bank holding company headquartered in Minneapolis, Minnesota, having been engaged in the general insurance agency business since 1929. Norwest recently acquired Centurion Life Insurance Company, a wholly owned subsidiary of Dial Financial Corporation on August 30, 1983 when Norwest acquired all of the stock of Dial. Although Centurion is primarily engaged in credit insurance, i.e., insuring the loans of its affiliated lending companies against the risks of death, disability or loss of property, Centurion had for many years prior to the acquisition, entered into reinsurance treaties on a regular basis with third party insurance companies. The Federal Reserve Board, as a condition of approving the acquisition, required that Centurion divest of its reinsurance treaties and desist from entering new treaties. The basis of the Federal Reserve Board's order was that the Bank Holding Company Act prohibits banks and their affiliated companies from engaging in any type of insurance underwriting other than credit insurance on loans made by members of the affiliated group. By reinsuring third party business Centurion was underwriting non-credit related business.

Reinsurance Treaties

Reinsurance treaties are contracts that pass all or part of the underwriting risk of a block of policies from the company originating the policies (the ceding company) to the reinsurance company (the reinsurer). The ceding company's motivation to reinsure is (i) to spread the risk of policies written in excess of legal or prudent limitations, (ii) to relieve a shortage in state insurance department required reserves to support the policies, and (iii) to maintain the ceding company's tax position. The reinsurer assumes the right (i) to share in the profits inherent in the block of business, (ii) to make use of reserves in excess of those required by the state insurance department to support internally generated business, and (iii) to maintain the reinsurer's tax position. Since reinsurance is driven by valid business motives, treaties will remain an every day occurrence. I believe it is safe to say virtually all insurance companies participate in reinsurance treaties as a tool for effectively managing their business to either lay off excess risks or assume additional business as a means of generating income.

Public Policy Issues

Credit insurance companies such as Centurion typically have excess reserves which are generated by a profitable and stable product. Reinsurance can be used by other companies needing additional reserves to support their products. The need to reinsure for reserve purposes is most common with young, fast growing insurance companies. Such growth is usually due to a product that has been adopted by consumers as offering superior benefits. By prohibiting bank credit insurance companies from acting as a reinsurer the law restricts the access of young, growing companies to needed reserves and denies bank owned insurance companies profits available to all other insurance companies.

Other participants in the insurance business have little reason to object to bank owned insurance companies acting as reinsurers of non-credit related risks. Reinsurance does not impact the insurance agency business. In fact, reinsurance is totally transparent to the agents. Since reinsurance offers a benefit to insurance companies, most companies should welcome the addition of companies such as Centurion as a customer. Unlike a direct underwriter, a reinsurer would not be competing for market share. Rather, reinsurance assists the ceding company in its pursuit of the market. Insurance companies in the same position as Centurion that are seeking reinsurance business may object to the entry of bank holding company insurance companies into the market place as new competitors. Such an objection would have no public policy foundation. Since reinsurance treaties are negotiated between insurance companies having equality of expertise and bargaining power, tying or undue coercion by a bank holding company of its loan customers is not an issue with reinsurance. It is noteworthy that insurance companies do not traditionally borrow from banks.

The long standing policy that bank holding company activities be of a financial nature, i.e., closely related to banking, is satisfied by the very nature of reinsurance. Reinsurers are in effect lending ceding companies the financial capacity to grow and manage their business. The ceding company repays the loan plus the equivalent of an interest charge. Reinsurance is akin to a commercial loan in that the ceding company (the borrower) leverages itself by sharing the risks and rewards of its enterprise with a reinsurer (lender).

The concern for the safety and soundness of bank holding companies can be satisfied by examination in the same manner as other bank business is currently reviewed by the Federal Reserve Board. Independent actuaries review the treaties and opine as to the safety thereof. State insurance departments review the safety of reinsurance transactions and require that such business be within the financial capabilities of the parties.

In summary, public policy reasons support reinsurance by bank held insurance companies, the activity is relatively non-controversial, and the public policy concerns regarding this business can be satisfied. Reinsurance has been a profitable, safe activity for Centurion. Therefore, Norwest respectfully requests that any legislation regarding bank holding companies contain authority for bank affiliated insurance companies to engage in reinsurance activities in accordance with existing state insurance standards.

We appreciate the opportunity for Norwest Corporation to submit this statement for the record.

Respectfully submitted,

Richard Levitt

BANKING DEREGULATION AS A BOON FOR LIFE INSURANCE BUYERS

Mark Frankel

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Findlay, Ohio

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INTRODUCTION

Life insurance purchased through an insurance company agent or broker is more costly than necessary due to high commissions paid for those sales. Therefore, this article advocates passage of legislation allowing banks to enter the insurance business, provided that banks allow consumers an alternative to the commission sales system which is presently the only real life insurance game in town. Savings banks in New York, Connecticut, and Massachusetts sell non-commission Savings Bank Life Insurance, (hereafter SBLI), pursuant to state laws and it is in the best interest of consumers for the SBLI principles to be extended nationwide by federal law.

Presently there is pending legislation entitled, 'Banking Deregulation', (S 1609), to permit federally regulated banks to sell insurance. The banking industry supports the bill because banks seek to expand the range of services they can provide. The powerful insurance lobby opposes deregulation because they fear the competitive marketing strength of banks. An amendment to limit banks to non-commission sales would not only benefit consumers, but would soften the blow of competition to the insurance industry, and still open a largely untapped market for the banks.

This article surveys the structure of life insurance marketing and the unnecessary costs to policyholders; remedies applied by government and the industry to reduce costs, with particular attention focused on SBLI; and the opportunity for expansion of low cost life insurance by allowing banks greater freedom to sell insurance.

LIFE INSURANCE MARKETING

It is a life insurance maxim that life insurance is not 'bought' and must be 'sold'. Nonetheless, the need exists to create a viable alternative to the traditional sales process for those buyers who would violate the sales maxim and purchase life insurance over the counter on their own initiative. This group of buyers is much smaller than those who must be persuaded to insure their lives, however the sales success of SBLI, (described below), indicates that the market of 'buyers' is large and growing. This section focuses on the two basic problem areas of life insurance marketing from the informed consumer's point of view: the high cost of insurance and the high cancellation rate of insurance. Unfair contract provisions will be looked at as well because they reveal attitudes that permeate the insurance industry, and thus help in understanding the basic problems.

High Cost of Insurance

The reason for the high cost of life insurance is the high cost of labor. For every sale an agent makes, he must go through an intensive sales process of finding prospects, contacting prospects, making appointments, conducting repeated in-home sales pitches, delivering policies, and collecting premiums. Few buyers are aware that life insurance salespeople are paid commissions of approximately one hundred percent of the first year premiums for such work. Virtually all individual life insurance sold by commissioned salespeople is sold on an in-home basis and those policies almost always cost more than policies marketed on a reduced or non-commission basis such as SBLI, mail order insurance, and group insurance.

To illustrate the high cost of commissions and in-home collection of premiums, 'Consumer Reports' calculated the relative costs of: 1) SBLI in N.Y., (no commission, no in-home sales, no in-home collection); 2) ordinary insurance, (commission sales, in-home sales, no in-home collection); 3) monthly debit ordinary insurance, (commission sales, in-home sales, in-home collection monthly); and 4) industrial insurance, (commission sales, in-home sales, in-home collection weekly). On $10,000 of whole life coverage for a 35 year old male, compared to SBLI, industrial insurance cost 67 percent more, monthly debit ordinary cost 41 percent more, and ordinary cost 15 percent more.[1]

Generally, consumers pay for home service only under exceptional conditions such as emergencies or for nominal purchases such as newspaper delivery. Policyholders should, therefore, view home sales and premium collection as a luxury and weigh the costs.[2] Unfortunately, buyers who actively seek to purchase policies without participating in the commission marketing system are more likely than not to be frustrated in their attempts. A spokesman described by 'Consumer Reports' as an "insurance regulator in an eastern industrial state" summed up the insurance industry defense of the high cost of insurance as follows:

> You can talk about people paying $700.00 for a $500.00 policy. Well, that's probably true. But if these people didn't have agents badgering them, they wouldn't have any insurance at all, and they might have no money to pay burial costs.[3]

High Rate of Cancellation

Cancellation of life insurance takes two forms: lapse for failure to pay premiums, and replacement of existing policies with new policies. Cancelled policies harshly penalize policyholders by the loss of accumulated cash values and loan privileges which do not accrue in the early years of policy ownership. A buyer who lapses or replaces a whole life policy before cash values have accumulated will have paid whole life prices for what has amounted to mere term insurance. Furthermore, if the same buyer purchases insurance at a later time, he will have lost the advantages of younger age and possibly better health.

The highest rate of lapse in the first year of policy ownership occurs in industrial insurance at 57 to 79 percent,[4] whereas first year lapses on ordinary business have been calculated at close to 25 percent.[5] Data collected on monthly debit ordinary from companies responding to a survey in 1974 by the Senate Subcommittee on Antitrust and monopoly indicates lapse rates "considerably higher" than those for ordinary insurance. The combined SBLI lapse rate for New York, Massachusetts, and Connecticut is well under 5 percent.[6]

The cause of high lapse rate is the commission marketing system. A salesperson earns commissions for policies that remain in force for more than one year. If a policy lapses in the first year for non-payment of premiums, the agent does not earn a commission from the sale. There is a very strong incentive for agents to oversell policies and absorb the lost commissions from first year lapses as a cost of doing business, (i.e. 'The more mud you throw on the wall, the more that sticks').

Insurance companies and agents object to being blamed for lapses which they claim are caused by economic conditions and faults in human nature.[7] In training agents, however, companies teach hard sell approaches to manipulate the customer to sign the application and close the sale on any basis that is arguably within the bounds of the law. It is a cruel irony that when a policy lapses, because the purchaser never wanted it in the first place, the companies turn around and self righteously attack the unfortunate buyer as a greedy profligate.

The most persistent abuse in life insurance sales is replacement of existing policies with new policies. Since commissions are based solely on first year premiums, many salespeople spend much of their careers persuading policyholders to forfeit their old policies and purchase "new" and "better" policies shortly after their old policies have been in force for a year. New York State requires agents to complete disclosure statements whenever a policy is replaced, but agents are accomplished at jumping through the hoops the law erects and replacement is common. Needless to say, replacement is rare in SBLI sales because policyholders are unfettered by agents after the purchase is made.

Unfair Contract Provisions

Unfair contract provisions were particularly offensive in industrial insurance. The 'facility of payment' clause found in industrial insurance issued by Prudential, for example, reads as follows:

> It is understood that the said company may make any payment or grant any non-forfeiture provision provided for in this policy to any relative by blood or connection by marriage of the insured, or to any person appearing to said company to be equitably entitled to the same by reason of having incurred expense on behalf of the insured, for his or her burial, and the production by the company of a receipt signed by any or either of them shall be conclusive evidence that such payment or provision has been made or granted to the person or persons entitled thereto, and that all claims under the policy have been fully satisfied.

Basically, the facility of payment clause allows insurance companies to settle death claims with anyone they deem appropriate, regardless of who the insured named as his beneficiaries in the insurance contract. Insurance companies claimed that such a clause was necessary to assure speedy and inexpensive settlement of claims,[8] and to deter speculative insurance.[9] Many undertakers, however, determined the value of a deceased's policies and accommodated the aggrieved family accordingly, knowing that they could collect their fees from the insurance company.[10]

Other clauses particular to industrial insurance include the prohibition of policy loans, prohibition of assignment of policies, and the holding of cash values until accumulated for ten years. The companies maintained that such clauses were necessary to prevent insureds from voiding the purpose for which the insurance was purchased.[11] By contemporary standards, the presumptiveness and paternalism of these provisions amount to no less than larceny.

Summary

The problems of life insurance sales are perpetuated by consumer reluctance to buy life insurance independently, and the result is a sales system that must rely on salespeople whose commissions alone will motivate them to persevere in the face of negative attitudes of buyers. The insurance industry has exploited its position as 'exhorter' by extolling a paternalistic attitude on the one hand, and running their business in a purely predatory fashion with the other. Exploitation of consumers under the guise of paternalism is evident in the companies' approach to overpriced products, ('its better that they should have it anyway'); unfair contract provisions, ('they need protection against themselves'); and lapsed policies, ('we tried'). Insurance people rationalize their business practices by convincing themselves that it is so important for every person to own life insurance that the means justify the end of closing sales. If the policyholder lapses or surrenders his coverage, at least the agent knows that he has done ALL that he could to protect the buyer. If an agent replaces a policy, it is implicit that the policyholder has suffered very little relative to the benefits reaped by the agent; and after all, this is America--the land of free enterprise where making a living is rarely painless.

Regardless of how one assesses this evangelical approach to insurance marketing, it is clear that the commissions necessary to support that strategy are very costly, and it is clear that there is no shortage of insurance companies to maintain the system. Therefore, if Congress is to allow banks to enter the insurance market, it should do so with the knowledge that there is good cause to diversify that market. Hence, a viable alternative should be contemplated for life insurance buyers who are already 'sold' and who would prefer to avoid the expense of being solicited.

ALTERNATIVES

Reform has improved the lot of insurance buyers in two ways: regulations have been enacted to deter marketing abuses, and alternatives have emerged for purchasing life insurance without the assistance of commissioned salespersons.

Regulations to Deter Marketing Abuses

States have enacted rules against misrepresentation, incomplete comparisons, 'twisting', rebating, and replacement.[12] Licensing exams for salespersons are mandatory in all states. New York took a bold swipe at life insurance costs in 1964 when maximum commissions for life insurance were statutorily set at 55 percent. Unfortunately, the impact of the 55 percent has not been as great as hoped for because liberal payments for "expenses" are allowed up to about 35 percent of first year premiums. Regulation has generally been effective in eliminating the most obvious abuses, but the basic unfairness to individual buyers implicit in unavoidable high commissions persists.

Recently, attempts have been made to attack the size of commissions by repeal of anti-rebate laws which prevent salespeople from offering portions of their commissions to persuade buyers to purchase insurance. The author has concluded in another work that repeal of anti-rebate laws is not advisable because a large increase in replacement would probably occur which would result in higher insurance premiums and restrict the variety of marketable products.[13] Regardless, no anti-rebate law has moved out of committee in any state legislature or the U.S. Congress. The insurance lobby is quite powerful and other strategies, for example, to statutorily lower commissions are likely to fail also.

Alternatives to Standard Commission Sales

Historically, the most significant alternative to the purchase of life insurance from a commissioned salesperson is, of course, Social Security Old Age, Survivors and Disability Insurance (OASDI). Virtually all gainfully employed Americans are covered by OASDI and, in 1970, 26 million persons received monthly benefits. In the context of Social Security then, the purchase of life insurance is usually made to defer dependence on the state. The consequence for the buyer, unfortunately, is dependence on a marketing system whose spoliative process is an unadorned threat to his financial wherewithall.

Insurance companies offer group insurance with reduced costs, but group insurance is generally limited to term insurance sold with the cooperation of employers, unions, and special interest groups. Mail order and telemarketing firms sell policies at significant savings and have managed to capture up to five percent of the life insurance market.[14] With names like "Ministers Life" and "Gerber Life", however, the buyer would do well to question the avariciousness of such operations.[15]

The only tried and proven method of marketing life insurance to individual buyers without commissions, without unfair contract provisions, and without high pressure sales tactics is Savings Bank Life Insurance. SBLI is offered in New York, Massachusetts, and Connecticut, and as the name implies, is sold only in savings banks. Generally, the provisions in a

SBLI policy are comparable to those of policies issued by other insurers, but there are several important differences: 1) no commissions are charged, 2) a first year dividend is made, and 3) cash surrender value is added in the first year.

Louis Brandeis was the creative driving force behind SBLI. His advocacy was inspired by the landmark Armstrong investigation conducted by the New York Legislature in 1905-06 which determined that industrial insurance was not meeting the needs of policyholders:

> Excessive premiums, enormous lapse rates, and the hardships of the agents seem to be inherent in the system. A great reform could be accomplished if the expense of solicitation and collection could be avoided by the enactment of branch offices where insurance could be obtained by the thrifty poor who deserve it.[16]

It is not unremarkable that excessive premiums and enormous lapse rates remain the biggest bugaboos of life insurance buyers, nor is it surprising that the 'Brandeis Way' is still the most effective remedy.

Massachusetts SBLI was established in 1907 by enactment of Chapter 178 of the General Laws. Presently, SBLI is limited to persons who live or work in Massachusetts and policy limits are set at $15,000 per person per bank, with an overall personal limit of $53,000 of coverage. In 1909, a bill to establish SBLI in New York was introduced, only to be withdrawn by its sponsor after it had been favorably reported on by the Senate Insurance Committee. After several other unsuccessful attempts, Justice Brandeis entered the drive to enact SBLI, and the passage of what is now Article VI-A of the Banking Law was secured in 1938. The limit of insurance is $30,000 per person and applicants must live or work in New York. SBLI was enacted in Connecticut in 1941 despite opposition from life insurance companies who argued that the 'insurance state' should protect its large taxpayers. One company representative feared that , "...the putting of the stamp of approval of Connecticut, the Insurance State, on SBLI will encourage its adoption in other states."[17] The limit of insurance is $15,000 in Connecticut, and applicants must live or work in that state. Savings banks exist in fourteen other states, but similar legislation introduced in those states has failed.

The performance of SBLI has been very good. In New York, SBLI is the fifth largest life insurer with six percent of the market.[18] In Massachusetts, SBLI represents 7.3 percent of the market, and in Connecticut SBLI issues 2.1 percent of the life insurance sold. The net cost to policyholders of all three systems is characterized by 'Best's Reports' as "remarkably low", and based on Best's analysis of financial position and operating performance, all three SBLI concerns were rated A plus (Excellent). Lapse rates are reported for the years 1976 through 1980 in New York at 5.1 percent, in Massachusetts at 3 percent, and in Connecticut at 3.1 percent.[19] The success of SBLI was explained by a retired chief executive of a New York life insurance company:

> As the retired chief executive officer of a New York-domiciled life insurance company, I for several years implored my fellow chief executives in trade associations to react strongly against the demonstrable appeal of SBLI. Obviously, I failed. And just as obviously, my failure and the failure of my fellow chief executives to react adequately has placed SBLI in a major and most powerful sales position in the New York State life insurance marketplace... Out of the approximately 300,000 licensed life insurance agents in these United States, one wonders how few of them are knowledgeable, competent salespersons, and have that one essential which seems so often to be lacking...integrity. My guess is that probably less than 10 percent fulfill this qualification and that is the reason why the public has turned from life insurance agents to mass marketing and savings banks when and where and how they can.[20]

For all of its success, SBLI has remained handcuffed. Year after year, bills have been introduced to allow sales of largr policies, and year after year those bills have died in committee. As happened in 1909 when SBLI was defeated in New York, often the bills are introduced by legislators friendly to the insurance industry so that they can preside personally over the demise of the legislation. State Senator John Dunne is a former New York State Insurance Committee chairman; the immediate past president of the National Conference of Insurance Legislators, and the chairman of a new task force in New York looking into the fitness of existing products and financial supermarkets.[21] He described the SBLI situation as follows:

> ...this is probably the single most emotional issue among life insurance salespeople--the threat of incursions of SBLI on their turf...
> ...my principal concern is that the consumer have ready access to as great a variety of products at competitive prices as possible, so I think all avenues should be approached. But, being a politician, I try to recognize that the producers represent a lot of people, a lot of votes and they are effective and persuasive in their presentations to the legislature. I try to respond in terms of what I see as doable. I don't think there is any legislator who wants to put the producers out of business. Legislators generally would like to help the producers.[22]

At least for the new few years, it is not only the New York Legislature who would help the insurance producers, but the New York Insurance Department as well. James Corcoran, former vice president of government relations for Prudential was recently appointed New York Insurance Commissioner.

There is only one significant case in which consumers brought their grievances regarding the limits of SBLI to the Courts. The Consumers Union, whose periodic studies of life insurance conclusively determined the exceptional value of SBLI, brought suit in Federal District Court challenging §266 of the New York Banking Law which limits SBLI to $30,000 of coverage, and §268 of the Banking Law which limits the sale of SBLI to persons who live or work in New York. Consumers Union lost the case after the case had bounced around in the Federal Court System, and it is safe to say that the reasoning of the ultimate decision is very unclear.[23] The reasoning of the

Superintendent of Banking and State Attorney General in deciding to press a defense against Consumers Union in the first place is even murkier. At a time when New York was investing millions of dollars in advertising to attract out-of-state businss, ("I love New York"), and at a time when savings banks were slipping into instability, it is a tribute to the power of the insurance lobby that the big guns were brought in to fight off what could have been a windfall for local financing, and for consumers everywhere.

CONCLUSIONS

1) The fundamental problems of life insurance marketing for consumers are a) the high cost of insurance due to the expense of high commissions; and b) the high lapse rate of policies due to overly aggressive sales practices to capture those commissions.

2) An alternative exists in SBLI that resolves these two problems, but SBLI is limited in scope by statute, and limited in its potential for expansion by political reality.

3) There is a need to create a new alternative to the present system of life insurance marketing that substantially reduces costs and lapses, and that can challenge the political power of the insurance industry.

4) Banking deregulation that would specifically preclude commission sales can effectively create the alternative contemplated.

The banking deregulation legislation under consideration could be amended to include this proposed change quite expediently. As an alternative to complete deregulation, insurance agents would maintain exclusive possession of about ninety percent of their market, (assuming that banks would be looking to the approximately ten percent of buyers who presently purchase non-commission policies). As an alternative to the defeat of deregulation, banks should also warm to the prospect of taking a large and growing share of what is probably the largest financial industry in the world. It is the consumers' interest, however, that is most important. Accordingly, Congress should be guided by the wisdom of Louis Brandeis when considering life insurance matters:

> The sacrifice incident to the present industrial insurance system can be avoided only by providing an institution for insurance which will recognize that its function is not to induce working people to take insurance regardless of whether they really want it or can afford to carry it, but rather supply insurance upon proper terms to those who do want it and can carry it--an institution which will recognize that the best method of increasing the demand for life insurance is not eloquent persuasion, but, as in the case of other necessaries of life, is to furnish a good article at a low price.[24]

1. Consumer Reports, 'Insurance That Preys on the Poor', November, 1978, p. 659.

2. LaPorte, Elizabeth D, Life Insurance Sold to the Poor: Industrial and Other Debit Insurance, U.S.G.P.O., Washington, 1979, p. 33.

3. See, Note 1, supra, p. 660.

4. See, Note 2, supra.

5. Rappaport, A.M., 'Consumerism and the Compensation of the Life Insurance Agent' in Transactions of the Society of Actuaries, (1977), p. 540.

6. Best's Insurance Reports - Life/Health, 1982, pp. 479, 1202, 1409.

7. Hedges & Henlee, Compensation of Life Insurance Agents, Indiana University Bloomington, 1942, p. 11.

8. The facility of payment clause was the subject of numerous lawsuits, and presumably this limited speedy and inexpensive recovery in many cases, see West's Insurance Law and Practice, Vol. 2A, Chapter 69, pp. 301-341.

9. Taylor, Maurice, The Social Cost of Industrial Insurance, Alfred A. Knopf, New York, 1933, p. 81.

10. Berman, Edward, Life Insurance, A Critical Examination, Harper, New York, 1936, p. 142.

11. See, Note 9, supra, p. 212.

12. Insurance law definitions:
misrepresentation - false statement about the terms, dividends, benefits or advantages of a policy, the financial condition of a company, or the legal reserve of an insurance company.
incomplete comparison - when comparing policies, agents must touch on each of six required points.
twisting - using misleading statements, misrepresentations, or incomplete comparisons to induce an insured to drop an existing policy and buy new insurance.
rebating - giving or even offering to give anything of value to induce a prospect to purchase or apply for insurance.
replacement - the substituting of a new policy for an existing one.

13. Frankel, Mark A., 'Insurance Agent Commission Deregulation: Anti Rebate Laws and an Alternative to

Repeal,' Journal of Insurance Regulation, December, 1983, pp. 260-261.

14. Donahue & Venuto, 'Mail Order' Insurance Takes on Polish; Telemarketing Becomes a Booming Business; in Best's Review - Life and Health, April 83.

15. For example, policies issued by many mail order companies are often vague about the amount of insurance and merely quote a low monthly premium. Colonial Penn Life Insurance Company, whose advertising blitz in 1984 features television personality Ed McMahon, is one such firm. The advertisements repeatedly announce the low monthly rate of $6.95 but bury the fact that the amount of coverage is $100.00. Therefore, over the course of a year, a healthy fifty-year-old man would pay $83.40 for $100.00 of term insurance! See Advertising Supplement to the Cleveland Plain Dealer, March 4, 1984, identified by the advertiser as "Policy Form Series No. 3-82-572."

16. Report of the Joint Committee of the Senate and Assembly of the State of New York, State of N.Y. Assembly Document No. 41, Vol X, 1906, p. 445.

17. Johnson, Donald R., Savings Bank Life Insurance, Irwin, Homewood, IL, 1963, p. 49.

18. Savings Bank Life Insurance Fund, Annual Report, 1980.

19. See, Note 6, supra.

20. Levy, Michael H., Letter to the Editor, National Underwriter - Life and Health, 1/24/81.

21. Senator Dunne was not always so keen on insurance: "For the first year or two on the insurance committee I was bored stiff. I'd say to my staff, 'Give me a good prison riot any day.'" Lyons, Lois J., 'A Portrait of a N.Y. Legislator,' National Underwriter - Life and Health, 2/5/83.

22. Lyons, Lois J., 'Senator's View on Insurance and Regulation,' National Underwriter - Life and Health, 2/5/83.

23. The Federal District Court upheld the constitutionality of the statutes and entered summary judgment for the State. Specifically, the Court held that neither limitation violates the Consititution because there is a rational basis in the laws in that they protect the insurance companies, and protect savings banks from neglecting their "traditional banking functions," Consumers Union v.

Albright, 427 F. Supp. 840 (S.D.N.Y. 1977).

Consumers Union appealed to the Supreme Court, that portion of the judgment upholding the constitutionality of the geographical limitation. (The plaintiff who challenged the policy amount limitation inexplicably did not appeal). The Supreme Court vacated the judgment and remanded the case "for further consideration in light of Hicklin v. Orbeck, 437 U.S. 518 (1978)." On remand, the District Court adhered to its previous decision, Consumers Union v. Gorin, Slip Opinion No. 74 Civ. 234 (LPG) (S.D.N.Y. 8/14/80).

Hicklin v. Orbeck, delcared a statute unconstitutional which required employers to give an absolute preference to Alaska residents for oil and gas resources jobs. The Court applied a two-prong standard for in-state preference: 1) States are required to show that non-residents are a "peculiar source of the evil" that the statute was enacted to remedy; and 2) States must show that the discrimination against non-residents bears a "substantial relationship" to the problem presented. Clearly, out of state residents were not the cause of the high cost and high lapse rate that SBLI was enacted to remedy, and clearly out of state residents, per se, do not bear a substantial relationship to the continued existence of those problems. On remand, the District Court, apparently felt that Hicklin was too liberal and a threshold requirement was added that was fatal to Consumers Union position. Consumers Union was required to show that limitation against non-residents,

> ...threatens a basic or fundamental right essential to the well being of the Union. 'Merely to ask the question seems to provide the answer.' Baldwin v. Montana Fish and Game Commission, 436 U.S. 371 (1978)

The Court implied that the opportunity to purchase goods and services is a basic fundamental right, but that the right was not deprived because SBLI was not considered a good or service, but rather a "social welfare program", (this, despite the fact that the Court acknowledged that §271 of the Banking Law prohibits state subsidies for SBLI operations). In the alternative, the Court noted that other states could establish SBLI for their citizens. Since other states might not choose to do so, the Court belittled its prior determination regarding the low cost of SBLI, and decided on remand that other insurance was comparable:

> Defendant cogently argues that the non-residents are not discriminated against by §268 because they are still able to purchase some commercial life insurance policies which are just as inexpensive and contain similar terms and conditions as SBLI...This Court's prior opinion assumed that SBLI was less expensive than comparable commercial insurance to avoid any dispute of material fact in deciding plaintiff's motion for summary judgment. Whatever dispute existed between the parties on this point has been resolved...

No longer constrained by disputes over material fact, the Court found that SBLI was not the only cheap insurance available and disposed of plaintiff's argument that New York was "hoarding" inexpensive insurance. The Court did not address the issue of whether New York was hoarding the right to purchase insurance from someone other than a commissioned salesperson.

24. Brandeis, Louis, 'Wage-Earners Life Insurance,' in Collier's, The National Weekly, Vol. 37, No. 25, reprinted in Mason, Alpheus Thomas, The Brandeis Way, Princeton University, Princeton, N.J., 1938, p. 311.

Jake/Dy

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1984 APR 27 AM 10: 25

April 24, 1984

Senator Jake Garn
Room 5121
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Garn:

In accordance with your reply to me - copy enclosed - advising that you "would be happy to include my written testimony in the hearing record", for that record, let's start this way . . . The Glass-Steagall Act should be reinforced, rather than modified in any way. The clear-cut separation of commercial banking from investment banking has been beneficial for the country and its economy for 50 years. Any deviation from that principle would be harmful.

For the record, those last two sentences could be repeated about a hundred times, because they tell the story.

However, for the record, the facts are . . . I went to work - as you know - in November, 1930 for a bank bond department. Consequently, I had four year's experience prior to the Glass-Steagall Act . . . and five years' after the Act, as I left the bank in 1939 to form my own company.

Because of that bank bond department experience, it makes me "ill" to hear conversation and/or discussion about allowing banks to have subsidiary companies which could handle any type of security. The reason those remarks are so upsetting is simply this . . . that is exactly what brought the Glass-Steagall Act into being.

It is my guess that not 1% of all members of Congress know that there were bank-owned subsidiaries handling all types of securities prior to the Glass-Steagall Act. In the early 1930s, the National City Bank had a subsidiary - the National City Company - and it had a branch here in Kansas City. As I recall they had over 15 salesmen and the salesmen making the most money were those who sold Republic of Chile bonds to more well-to-do Kansas wheat farmers. It has been documented that the National City Company sold many, many shares of the bank stock at a price of about 90 - (it was supposed to go to 100, of course). Subsequently it was learned that the shares being sold were owned by the chairman and president of the bank . . . and the stock was selling around 10 a few years later.

The Chase Bank had a subsidiary named Chase-Harris-Forbes and it, too, had a branch here in Kansas City. Another outstanding example was the First of Boston Corporation which was a subsidiary of the First National Bank of Boston. After the Glass-Steagall Act, many of the employees formed what is today's - First Boston Corporation. Just these three examples of subsidiaries with branches way out here in Kansas City should point out that - "Bank subsidiaries should not be considered".

In your address to the SIA, you mentioned that "old laws had been inherited to deal with present day innovative financial services". The basic fact is that some of those "old laws" are more important today than they were when they were enacted. Think what a bank bond department can do today with computers. Further, you mentioned that Congress should legislate "only for the sake of the good of the country". The good of the country has been the sharp delineation of commercial banking from investment banking. By the same token that banks should not be allowed to handle securities of any type, it should be legislated that investment banking firms not be allowed to perform normal banking procedure, eliminating the writing of checks and similar "true banking practices".

Once you mentioned that Congress should not be too concerned about specifics . . . but rather make the general good of the country their prime objective.

Putting that in practice in view of my experience, Congress should be focusing on the overall good for our country by reinforcing the separation of commercial banking from investment banking . . . and not bother about the details except enforcing the situation as it was before investment banking firms started check writing and making similar inroads into commercial banking. Stop those inroads . . . and, likewise, stop the inroads of banks thinking about having securities subsidiaries.

Repeating, prior to the Glass-Steagall Act, a specific example of what might be styled "nefarious" bank bond department dealings was the experience I had of actually knowing of a commercial loan to an individual who used the funds to build a building for an automobile dealership. When the loan became what might be called "shaky", a bond issue was sold and many of the purchasers were the bank's customers. The proceeds from the bond issue were used to retire the bank loan . . . and the bonds subsequently defaulted.

Another specific example is the case of a lumber company which had a commercial loan of good size in one of the larger banks here. The bank, in order to make certain the loan would be paid, had the lumber company issue bonds which were not readily saleable because the general investing public felt that the company was not too sound. However, the bank loan was paid off and the only place that the bond department could sell the bonds readily was to its trust department. I personally bought some of those bonds a few years later as low as 30¢ on the dollar. Incidents such as these were repeated many, many times, and many on a larger scale throughout the country.

Again, I doubt that 1% of all members of Congress know that the original version of the Glass-Steagall Act unqualifiedly prohibited banks handling any securities of any type. The banks "lobbied" Congress saying that - "Certainly you want us to help you with your government bond financing . . . so you should let us handle government bonds". That, of course, made sense. Then the banks took it one step further and pointed out that the "little old school district" out in the country would also need financing, so the banks should be allowed to handle school bonds and other general obligations. As that also made sense, that is the way the Glass-Steagall Act was finally enacted.

Repeating now, the Glass-Steagall Act originally prohibited banks from handling any securities because the purpose was to have a distinct separation of commercial banking from investment banking . . . and that is the reason for my opening statement that the "Glass-Steagall Act should be reinforced . . . not modified or altered in any way".

Senator Jake Garn

Page 3
April 24, 1984

I hope the foregoing has been of interest to you, Senator, and I am grateful for your consideration. I only wish that each Congressman could forcefully be made to know, realize and appreciate that bank subsidiaries handling all types of securities was bad for our country, causing the passage of the Glass-Steagall Act.

To me, any consideration of bank subsidiaries is identical to consideration of going back to Prohibition. Neither worked before and neither would work now!

Thank you for this opportunity to have these facts added to the record. Far more important, would be the education of every single Congressman, enlightening them to the "banking securities subsidiaries era of 1926 to 1934". Each member of Congress should know those facts, or, at least, be vaguely familiar with them. How can that be accomplished for the benefit of our Country. How can every Congressman be made to know that securities subsidiaries of banks didn't work before, and wouldn't now!

Sincerely,

Victor H. Zehner

VHZ/ph

Testimony of
National Association of State Savings Insurers
before the
Committee on Banking, Housing and Urban Affairs

March 27, 1984

Mr. Chairman, the National Association of State Savings Insurers ("NASSI") appreciates the opportunity to present testimony regarding your bill, S.2181 and Senator Proxmire's bill, S.2134.

NASSI represents deposit insurance and guaranty funds created by state legislatures in Maryland, Massachusetts, North Carolina, Ohio, Pennsylvania, and Rhode Island. These funds insure approximately $29 billion in deposits held by some 9 million depositors at 624 institutions.

The financial institutions whose deposits we insure include savings and loan associations, credit unions, savings banks, industrial thrift and loans, and industrial banks. They represent the state side of the dual banking system in its purest form as they are chartered, supervised, and insured without any federal involvement.

The existence of institutions which do not have federal deposit insurance serves an important public policy purpose by permitting innovation which could not take place in a totally federally regulated environment. These institutions have historically been on the leading edge of the development of new consumer products: NOW accounts, variable rate mortgages, and deregulated interested rates on savings deposits all were in place at state-insured institutions before they were permitted by federal deposit insurance regulations. The non-federally regulated financial industry has provided a laboratory for the development of new financial products, and the healthy competition which has existed between these institutions and their federally regulated counterparts has made our nation's financial system more innovative and more vibrant.

The Federal Reserve has recently amended Regulation Y in an attempt to close the so-called "non-bank bank loophole" by regulation. One of the effects of this move if it were to be upheld by the courts, would be to bring non-federally insured institutions under the definition of "bank" for purposes of the Federal Bank Holding Company Act. In so doing, the Fed has sought (1) to impose the federal bank holding company regulatory structure on institutions which are state-chartered, state-supervised, and state-insured; and (2) to require these institutions to become insured by the FDIC if they operate in holding company form (required by section 3(e) of the Bank Holding Company Act). NASSI believes that this is an unnecessary and unwarranted imposition of federal supervision and federal deposit insurance on state institutions. It would undermine the dual system of regulation under which these institutions have historically operated and would restrict the competition between the federal and state systems which has provided benefits to banks and consumers alike.

The Committee now has before it a number of proposals that address the issues of what is a "bank" for purposes of the Bank Holding Company Act, all intended to respond to the so-called "non-bank bank loophole." The problems raised by non-banks have to do with who may own federally insured depository institutions; state-insured institutions do not have to be brought under the federal regulatory and insurance system in order to resolve those problems. Mr. Chairman, in your introductory remarks on Section 2181 you stated with reference to the institutions which we represent, "Since they are not federally insured, there appears to be no reason why the federal bank holding company regulatory scheme should be imposed on their operations." We concur and ask that, as this Committee marks up legislation, non-federally insured institutions be excluded from the amended definition of "bank" as you have suggested.

Non-Bank Banks

Over the past few years, a number of business firms have sought to acquire or charter depository institutions which are FDIC-insured in order to gain the advantages of federal deposit insurance. By restricting the operations of the depository institution so as to avoid its being a "bank" as defined in the Bank Holding Company Act, these business firms have been able to achieve the benefits of federal deposit insurance without becoming subject to the activity restrictions of the Bank Holding Company Act. This has enabled the holding company to engage in the securities business or the insurance business while owning as one of its subsidiaries a non-bank bank with FDIC deposit insurance. While this opportunity has existed for the last 13 years, a dramatic surge in the number of non-banks formed has only occurred in the last few years. The reason for this phenomenon, it appears, is the substantial deregulation of federally regulated banks since 1980.

It is clear that the reason firms like Dreyfus, Merrill Lynch, and Prudential want bank charters is to take advantage of federal deposit insurance. These financial firms could offer the same or more attractive savings and investment products to their customers without a bank charter, but these products would not be backed by federal deposit insurance. Such phenomena as "brokered deposits" and "non-bank banks" are nothing more than an effort to take advantage of the fact that institutions with federal deposit insurance are able to compete for investor dollars using the federal government's credit rating. The more banks with federal deposit insurance are deregulated, the more pressure there will be for other participants in the financial marketplace to obtain the advantage of a federal guarantee.

The Federal Reserve's amended Regulation Y is an attempt to respond to the non-bank bank problem by regulation, but, if upheld by the courts it would result in the imposition of the Federal bank holding company regulatory scheme and mandatory federal deposit insurance on state-chartered, state-insured depository institutions as the price for doing the business in a holding company. Holding companies of state-insured depository institutions that previously operated under state law would suddenly become subject to Federal Bank Holding Company Act restrictions, and if revised Regulation Y remains as it now stands, many of them will have to divest their depository institution, take on federal deposit insurance, or do both.

Apparently in reponse to the problems that revised Regulation Y raised for state-insured institutions and their holding companies, on February 2, 1984, the Federal Reserve Board determined to exempt from Regulation Y companies that, before December 10, 1982, acquired state-chartered savings and loan associations, the deposits of which are insured under state law, provided that those institutions limit their activities to those permissible for federal thrift institutions under the Homeowners Loan Act (emphasis added). Unfortunately, this so-called exemption, which is conditioned upon the state-chartered savings and loan insured under state law limiting its activities to those permissible for federal thrift institutions, still has the effect of subjecting the operation of state chartered, state-insured savings and loan associations to the federal regulatory structure. The "exemption" enables certain existing holding companies to remain in existence, but does nothing to address the real problem which is the extension of federal regulation to purely state institutions.

The expansion of Regulation Y to cover state-insured depository institutions and their holding companies has raised a number of specific problems for NASSI's members and the institutions they insure:

1. In Ohio, institutions insured by the FSLIC have been operating as holding companies for state-insured savings and loans. The Fed's action has transformed the state-insured S&Ls into banks with the result that the company now operates as both a thrift and a "bank." This is not permissible under section (4)(c)(8) of the Bank Holding Company Act and the only options are divestiture, acceptance of FSLIC insurance (which would transform the state S&L into a federally regulated thrift), or, if the S&L was

acquired before December 10, 1982, restriction of the state S&Ls activities to those permissible for federal thrift institutions.

2. In Rhode Island, Utah, Minnesota and other states, many state-insured industrial banks are owned, in accordance with state law, by companies whose activities are not considered by the Federal Reserve to be "closely related to banking." These industrial banks are now "banks" under Regulation Y, and they must be divested since the activities of their holding companies are not permissible under federal bank holding company regulations. Those banks whose holding company activities are permissible must become FDIC-insured if they wish to continue to operate within the holding company.

3. In Massachusetts, state-insured savings banks and cooperative banks have the authority to convert to stock form. These institutions are now "banks" under the Bank Holding Company Act, and they will not be allowed to form holding companies (even unitary holding companies) unless they switch to federal insurance and submit to the federal holding company and federal deposit insurance regulatory structure.

The Federal Reserve's attempt to extend the reach of the Bank Holding Company Act to cover state-insured institutions is not only, in our view, contrary to Congressional intent, but is patently unnecessary to deal with the so-called "non-bank bank" problem. There has been no rush by securities firms or insurance companies to acquire instutitions which are insured pursuant to state law, and there is no reason to bring these institutions, which have operated without any federal involvement for many years, under the Bank Holding Company Act and to force them to obtain federal deposit insurance.

Congress in enacting the Bank Holding Company Act provided that "The enactment by the Congress of this chapter shall not be construed as preventing any state from exercising such powers and jurisdiction which it now has or may hereafter have with respect to banks, bank holding companies, and subsidiaries thereof." Revised Regulation Y has done just this by preempting the states' authority over purely state depository institutions and their holding companies and by requiring federal insurance and regulation as a condititition to state-insured depository institutions operating in a holding company.

There are a number of proposals for dealing with the non-bank bank loophole before this Committee, ranging from a simple moratorium on non-bank banks to a comprehensive rewrite of the Bank Holding Company Act. NASSI and the institutions which our deposit insurance funds serve have an interest in the outcome of the non-bank bank debate, but we are not here to take a position on the relative merits of the various proposals before you as they affect the operations of institutions with federal deposit insurance.

What we do ask is that Congress and the Federal Reserve Board recognize that the institutions we represent, which were chartered, supervised, and insured under state law without any federal involvement, should continue to be regulated by their respective states and not be unduly burdened by unnecessary federal regulation and mandatory federal deposit insurance. This can be accomplished by excluding state-insured depository institutions from the definition of "bank" in the Bank Holding Company Act.

Mr. Chairman, when you introduced Section 2181, you recognized the lack of any compelling public policy justification for bringing state-insured institutions under the Bank Holding Company Act umbrella and the resulting requirement of federal deposit insurance. We agree. It seems to us that the issue raised by the Federal Reserve Board's actions on February 6 is whether in the name of preventing the spread of non-bank banks, the Federal Reserve Board may accomplish a virtually complete federal preemption of depository institution holding company activity and mandate federal deposit insurance. It would be more than ironic that such a federal preemption of the historic state role would have occurred during the present Administration, perhaps the most committed of any in the past fifty years to preservation of the role of the states, and during a time when members of both parties are calling for less control from Washington. It would be a blow to the dual system of chartering and regulation of financial institutions in our country.

In its February 29 testimony before this Committee, the National Association of State Savings and Loan Supervisors, in making the point which you made in your introduction of Section 2181, implored this Committee to petition the Federal Reserve Board to refrain from bringing the State-insured institutions under the Bank Holding Company Act and the requirment of federal deposit insurance. We too make this request of you, particularly if legislation is delayed. The disruption which Regulation Y will cause in the operation of state-insured institutions and the paralysis which it is already causing in their corporate planning is simply not justified. The Federal Reserve Board must be given a clear signal that Congress does not intend that the Bank Holding Company Act be applied to institutions insured pursuant to state law.

CONSUMER CREDIT INSURANCE ASSOCIATION
307 North Michigan Avenue Chicago, Illinois 60601 (312) 726-9895

JOHN R. WALKER
GENERAL COUNSEL

April 6, 1984

Mr. William W Wiles
Secretary
Board of Governors of the
Federal Reserve System
Washington, D.C. 20551

Regarding: Proposed Amendment to Regulation [12C.F.R. Part 225]
Docket No. R-0491

Dear Mr. Wiles:

On January 20, we took the opportunity to offer our comments concerning the captioned on behalf of the one hundred seventy (170) insurers that are members of the Consumer Credit Insurance Association (CCIA). Subsequently, we received a copy of a statement filed on behalf of the National Association of Insurance Brokers, National Association of Casualty and Surety Agents, Professional Insurance Agents and the National Association of Underwriters. Since that statement (hereinafter "the statement") constituted what we feel is an unwarranted attack on the credit insurance industry, we wish to take this opportunity to respond to the more outrageous allegations which we feel are an inaccurate protrayal of the Credit Insurance industry as it exists today.

On page 10 of the statement, we find a summary of the alleged abuses:

> "Rapacious overcharging, failure to return unearned premiums when loans are paid off or the borrower dies during the term of the loan, failure to notify survivors of borrowers

> that loans have been paid off by credit insurance and tying sales of credit insurance to extensions of credit" etc.

Though these allegations seem remote from the proposed amendment under consideration by the Board we would wish to respond with our comments.

(1) **Rapacious overpricing.** We categorically deny the blanket suggestion that Credit Insurance is overpriced. The fact is that Credit Insurance rates are established in each state either by legislative action or Insurance Department regulation. The process includes public testimony by interested parties. The resulting rate is the best judgment of the legislature or Insurance Department based on the evidence submitted. According to figures supplied by the National Association of Insurance Commissioners, in 1982 the total premium for Credit Life and Accident and Health insurance in the United States amounted to $2,632,987,000. This is indicative that there were a rather large number of people who were satisfied that they were getting their money's worth when they purchased the coverage.

(2) **Failure to return unearned premiums.** If this were ever a practice, we respectfully submit that it has long since been eliminated. Credit insurance policies and certificates carry explicit language regarding cancellation. They would not be accepted for approval by the various insurance departments if such provisions were not present. Further, state insurance and/or banking regulations as well as laws generally contain

specific provisions mandating such refund[1]. We are unaware of any recent evidence of consumer complaints regarding this allegation.

(3) **Failure to notify survivors of borrowers that loans have been paid off by credit insurance.** Now, this is certainly the most incredible and unfounded charge of all. The author of the statement would have us believe that the creditor would somehow manage to secure the benefits of the Credit Insurance from the insurer without the knowledge of the deceased's survivors and then, presumably, continue to collect on the debt. Beyond suggesting that a bank would condone such fraudulent activity, someone is obviously unaware of insurance claim practices. When a death occurs there is the required notice to the insurer; the completion of required claim forms; and submission of certified copy of the death certificate. The notion that this would be done without knowledge of the deceased's survivors tests one's credulity to the limit.

(4) **Tying extension of credit to the purchase of credit insurance.** This is the most common charge formulated by the agent's lobby. It is usually accompanied by isolated instances which are said to represent a general practice. Coercive tying is a violation of both State and Federal law. If it occured with the frequency suggested by the agents we could expect a plethora of criminal

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[1] For instance see State of Ohio Regulation 3901-1-14, Section (D)(3).

prosecutions, not to mention civil class actions. The absense of such litigation is eloquent testimony that this charge is more myth than actuality.

In addition, how many studies will it take before the detractors of Credit Insurance awake to the fact that despite all of their criticism the most important party involved, the consumer, likes the product? The 1978 study of Tying undertaken by your staff explicitly rejected the notion that tying was a wide spread practice. Further, the widely quoted Ohio University study[2] carried the following responses to questions posed to purchasers of credit insurance:

> (A) Would you like to cancel the credit life insurance coverage on your loan with us and get a refund? 91.16% said "No". Does this suggest "coercion"?
>
> (B) If you were to borrow money in the future, would you want the amount of the loan covered by credit life insurance? 91.50% said "yes". Does this suggest a premium rate that is the result of "rapacious overpricing"?
>
> (C) Even a higher percentage (94.21%) said "yes" when the question was posed regarding credit accident and health insurance. Does this suggest "coercion"?

Mr. Wiles, If the truth be told, we suspect that the various organizations that propounded the statement really have a minimal interest in a bank's activities so far as credit life and credit accident and health insurance is concerned[3]. Anyone who reads

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(2) See Hubbard, Consumer Credit Life Disability Insurance (Ohio University 1973) pp. 79-81.

(3) For instance, would anyone seriously contend that a Surety Bond agent would have any real interest in a Bank's credit insurance writings?

the trade papers and attends the hearings knows that the ultimate object is to deny banks the opportunity to participate in the general insurance business. Why should that objective be served by attacking credit insurance? We suggest that the opponents of the banks in this instance need a "stalking horse". The familiar tactic of keeping your adversary busy defending himself on an unrelated subject so as to divert him from his main objective would seem apparent as the underlying motive for the charges found in the statement.

In closing, we hasten to add that the CCIA has no formal position as to how extensive the insurance activities of a bank should be. We do feel, however, that it would be only fair that banks be subject to the same laws and regulations as other lenders and that the merit of credit insurance is not an issue in this proposed rulemaking.

Yours very truly,

John R. Walker
General Counsel

JRW/kmh

COMPETITIVE EQUITY IN THE FINANCIAL SERVICES INDUSTRY

PART III

WEDNESDAY, MARCH 7, 1984

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, D.C.

The committee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Gorton, Hecht, Proxmire, Riegle, and Sarbanes.

OPENING REMARKS OF CHAIRMAN GARN

The **Chairman**. The committee will come to order.

Today we are continuing the series of hearings on S. 2181 and S. 2134, the financial institutions deregulation legislation. I believe we have had some extremely good hearings, good testimony, from a lot of fine, articulate witnesses over the last few weeks and today is no exception.

Our first panel is composed of two distinguished gentlemen, Mr. Richard Jenrette, chairman, Securities Industry Association; chief executive officer, general manager, Donaldson, Lufkin & Jenrette, New York, N.Y.; and Mr. David Silver, president, Investment Company Institute.

Mr. Jenrette, would you like to begin.

STATEMENT OF RICHARD JENRETTE, CHAIRMAN, SECURITIES INDUSTRY ASSOCIATION; CHIEF EXECUTIVE OFFICER, GENERAL MANAGER, DONALDSON, LUFKIN & JENRETTE, NEW YORK, N.Y., ACCOMPANIED BY ED O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. **Jenrette**. Thank you, Mr. Chairman. My name is Dick Jenrette and I'm chairman of the Securities Industry Association. I am also chairman of the Donaldson, Lufkin & Jenrette, an institutional insurance brokerage firm, insuring banks, insurance companies, mutual funds, and brokers. We are also the New York correspondent for several hundred regional securities firms.

I have with me today SIA president, Ed O'Brien. We're very pleased that you have graciously invited us to appear before the committee this morning.

I have been on Wall Street for nearly 30 years—this is testified by the bald head——

The **Chairman**. Well, I'm bald and I'm not on Wall Street. In fact, I like all three of your hairlines. [Laughter.]

Mr. **O'Brien**. 35 years of experience.

Mr. **Jenrette** [continuing]. Or some 60 percent of the time since the Glass-Steagall legislation has been in existence. During most of this time, the banks and the securities firms coexisted happily and were customers of one another. We borrowed from the banks, we executed orders for their trust departments, and we introduced corporate clients to them for short-term financing. To a great extent this is still true today. We get along very well together. And the differences in point of view have been blown all out of proportion, in my judgment, by the press and others who like to pit one group against another.

FRICTION IN RECENT YEARS

But undeniably there has been friction in recent years. I date this to the advent of the money market funds. At that time, undeniably the banks were fighting with one hand tied behind them because of the interest rate ceilings which made them uncompetitive in the marketplace. Mr. Chairman, you and Chairman St Germain were in the vanguard of those who recognized this problem and the result was the Garn-St Germain legislation which freed the banks from their competitive disadvantage. Since then, some $300 billion has flowed into bank money market accounts. Indeed, Citicorp now advertises in full page ads in the newspapers, "The Undeniable Advantage of Managing Your Money Through a Banker, Not a Broker." The facts are the banks now have a competitive advantage vis-a-vis the brokers in that they can offer FDIC guaranteed deposits. It is this competitive advantage that is now making some members of our industry seek their own FDIC guaranteed nonbank banks.

The banks' response to the competitive inroads in their deposit base by the broker money market funds was to counterattack by finding a loophole that allowed them to enter the brokerage business—through the acquisition of discount brokers such as Charles Schwab, which was purchased by Bank of America, or setting up their own brokerage facilities. There is no doubt in my mind that the banks rush to get in the brokerage business was triggered by a desire to close the hole in the loop which existed when bank customers had to send money to a broker whenever they wanted to buy and sell stocks. The brokers were no longer returning the uninvested proceeds to the banks but instead were putting them in their own money market funds.

And so a vicious cycle has started, led by the two largest entities in each industry. Most of us are being dragged along even though we really don't want to get in one another's backyard.

Mr. Chairman, I fervently wish both sides would sit down together and thrash out this matter, as I know you would like us to do. The fact is our industry is not a monolith. While I trust I speak for the vast majority of participants in the securities industry, there are some differences of opinion. Clearly, a similar situation exists on the banking side. So we are reduced to looking to Congress to resolve this dispute. Congress separated the two industries in the first place, and it seems this matter won't be resolved until you make it clear we are to be one industry or two.

While my testimony may sound like I am preserving a vested interest, I truly believe that the principles behind the Glass-Steagall legislation are sound, even though they've been around a long time, and basically have served the Nation very well. In times of prosperity such as we have now, the risks in our industry may not seem great. The last time the banks were given underwriting powers was in a similar period of prosperity under the McFadden Act in 1927. We got into big trouble shortly thereafter. I am not saying that caused the depression, but in the wake of the crash many of the bank underwriting relationships looked highly incestuous and were impossible to explain to people who had been wiped out. We've included a bit of this history in appendix B to our statement and I hope you will take time out to read that piece which might be called negative nostalgia.

Right now we have a system which really works well. I have talked to many corporate financial officers, and while they are not speaking out now because they'd like not to take sides at this time, most tell me they view with distaste the possibility that they would be dependent on the banks for both short-term and long-term financing. They like being able to go to a separate underwriter of their choice to sell equity and debt. Similarly, we have found no clamor from investors generally to expand bank powers. Indeed, banks face growing hostility from their customers for slowness in clearing checks, refusal to cash checks, fees, and so forth. Incidentally, I also feel this idea or notion that one-stop shopping is what everybody wants from their financial services has got a strong propaganda element in it and I'm not at all sure that everybody wants one-stop shopping, but we can talk about that in the question and answer period.

Banks today are faced with the challenge of interstate banking, plus overseas and domestic loan problems, plus a capital base that has been described even by the Federal Reserve as inadequate to their present business. I can't for the life of me figure out why they want to take over the securities business at this point in time.

DEREGULATION SHOULD SERVE THE PUBLIC'S INTEREST

I would also like to take one stab at this deregulation topic. The idea that all deregulation is good and all regulation is bad is certainly an oversimplification at best. I am all for deregulation as long as it serves the public interest. But how can banks complain about regulation when the Federal Government is guaranteeing nearly $2 trillion of their deposits? They borrow from their depositors on the Government's credit and relend on yours and my credit. This interest rate arbitrage, which is what we would call it in our business, has been very profitable for the banks over the years. The banks have a record of consistent profitability over the years despite claims of being at a competitive disadvantage today, which I find almost laughable. Citicorp—the leader among banks—is enjoying all-time record profits.

In any event, those who use Federal credit should expect to have some limitations placed on what they can do. This is not like deregulating the airlines or the railroads. The FDIC guarantee gives banks an overwhelming advantage in terms of low-cost capital. If the banks want to be deregulated, let them give up their FDIC guarantee and let their balance sheets speak for themselves. Insurance companies effectively take deposits in the form of insurance premiums, and the customers appear to feel their funds are safe. Maybe it's time for these big banks who don't want to be regulated to get off the Federal Government's credit. Chairman St Germain last week remarked that maybe it's time we have two kinds of banks—federally guaranteed banks that accept some limitations in their powers and private banks that forego FDIC guarantees and do exactly as they wish.

Since I doubt many banks will give up their FDIC guarantee, I can only conclude by saying that the present system we have is the best in fact that anyone has ever devised and works well here and in Japan which is modeled on the U.S. pattern. Those nations such as Germany which are dominated by universal banks that do everything have dull markets, far higher transaction costs in buying and selling securities, and no capital for emerging growth companies or venture capital for startup companies.

While none of the proposed legislation goes all the way in breaking down Glass-Steagall clearly each piece of our buiness that is sliced off and opened up to banks, such as the proposal to underwrite revenue bonds, weakens our overall sales distribution marketing system. As these slices are taken eventually what is left will not be viable and the remaining business will have to be taken over by the banks and we'll be right back where we were in the late 1920's.

All this points up why Congress must review this entire matter carefully before it acts, and you're certainly doing that, witness this hearing, and I thank you for your kindness in inviting SIA to appear before this committee.

That concludes my remarks.

[Complete statement follows:]

Testimony of Securities Industry Association

Presented By

Richard H. Jenrette
Chairman of the Board of Directors
On S. 2181 and S. 2134

Before

The Senate Committee on Banking,
Housing & Urban Affairs

March 7, 1984

Introduction

Mr. Chairman and members of the Committee, I am Richard H. Jenrette and appear here today as Chairman of the Securities Industry Association ("SIA"). In addition to my duties as Chairman of SIA I am also a founder and Chairman of the Board of Donaldson, Lufkin & Jenrette, an institutionally oriented securities and investment banking firm. Our firm is also the New York correspondent for more than 200 regional securities firms. My experience in the securities business now extends to nearly 30 years. Appearing with me today is Edward I. O'Brien, the President of SIA, whose experience span in the business is similar in length to mine.

SIA is a national trade association representing more than 500 organizations responsible for the vast majority of the securities brokerage and investment banking business of the nation. The business of our members includes retail and institutional brokerage, over-the-counter market-making, underwriting and other investment banking activities, and various exchange floor activities. The size of our member firms, whether measured in terms of net capital, number of account executives or offices, ranges from the very largest wire houses serving the entire country to small local firms. On behalf of that entire membership I express appreciation for the opportunity to appear before your distinguished Committee today. At least institutionally speaking, your Committee and SIA have come to know each other quite well in recent years. Our presence today represents the fifth time in the three years you have been Chairman of the Committee, Senator Garn, that we have been privileged to accept your invitation to testify concerning the many important and complex issues involving the financial services industry.

In large part as the result of your Committee's efforts, particularly as fulfilled in the legislation known as the Garn-St. Germain Act, very significant changes have occurred in the financial markets during the past three years. When we appeared before you in the Spring of 1981 you expressed an overriding concern about "the regulatory and competitive positions of depository and non-depository institutions with respect to the offering of securities-related services." You were alarmed by the growth of money market funds which you attributed to government policies that had allowed securities firms to compete unfairly with depository institutions for savings, a view enthusiastically supported by the banking and thrift industries. Well, times have changed. In just the short span of two years since the enactment of Garn-St. Germain, which allowed banks and thrifts to create and offer a "competitive instrument" to attract deposits, the situation is vastly different. Over $300 billion has flowed into federally-insured market rate deposit accounts -- more than was ever in money market mutual funds. By making possible the creation of this new deposit instrument you also not only strengthened the troubled thrift industry, but helped many a commercial bank as well. We find Citicorp running a series of ads in the New York Times with the lead: "THE UNDENIABLE ADVANTAGES OF MANAGING YOUR MONEY THROUGH A BANKER, NOT A BROKER." The ad proceeds to identify 10 factors which CitiBank asserts makes FOCUS, the trademark for its money market account, superior to the CMA (cash management account) offered by Merrill Lynch. A copy of the ad is appended to our statement (A). Interestingly, the ad omits reference to the most important advantage enjoyed by banks - their ability to attract FDIC insured funds.

When the advocates of expanding powers for the big banks, initially the Dealer Bank Association, but now joined by the ABA and other depository organizations, were pressing their case a few years ago it was for new municipal revenue bond powers so they could bring alleged savings public issuers. That argument was effectively destroyed in an extensive hearing in the House of Representatives in 1979 which one would have thought marked the end of it. But, no, with a new Congress in 1981 the banks were back, still seeking broader revenue bond powers, but also asserting their need for money market fund powers to combat money market mutual funds. They did not just ask for money market fund powers, however, but the power to sponsor, underwrite and distribute all mutual funds. The securities industry, among others, observed that the problem was not mutual funds but unrealistic deposit interest-rate regulation in times of extraordinary inflation. Congress agreed and, without objection from the securities industry, Garn-St. Germain gave the banks more than they sought -- money they can use in their own business.

So Congress had more than met the specific need for which the thrifts and banks had sought mutual fund powers. Was that the end of it? No indeed. The banks are back - still seeking revenue bond powers without having proven their case, still asking for mutual fund powers, although Congress had given them relief from their interest rate problems, and now asking for even more, the authority to underwrite and deal in privately sponsored mortgage backed securities, which trade like and under securities law are treated just like corporate debt. If such powers are granted, there will be precious little left of the Glass-Steagall Act.

The economic environment has improved substantially since the Spring of 1981 when we testified before the Committee on competition and conditions in the financial system. Nearly all providers of financial services are stronger now than they were then and as a consequence the public is more efficiently and better served. This is certainly true in our industry as the following references to some industry statistics reveal.

Well known, and well advertised, is the increase in NYSE trading -- from 49 million shares a day in 1981 to 65 million in 1982 and then to 85 million in 1983, punctuated by a series of 100 million plus share days.

But NYSE volume is only part of the story. Often overlooked is the tremendous increase in other trading activity on Wall Street. Most stunning is the increase in OTC trading volume.

- NASDAQ -- in 1978 volume was 16 million shares a day; it grew to 33 million in 1982 and to 60 million shares a day in 1983.
- AMEX Volume -- is now 8.6 million shares a day, up 75% versus the 4.9 million shares a day in 1982.
- Options Volume -- on the CBOE, for example, there were 133,000 contracts traded daily in 1979. In 1983 volume is at about 316,600 contracts daily. That's a 2-1/2 fold increase in the last 3 years.
- Bond trading is also up dramatically.

And, our industry is doing an incredible job of raising new equity capital for U.S. companies -- not debt capital but permanent equity capital. And we've done it predominantly for small business -- emerging growth companies.

- Last year our industry raised an all time record of $40 billion of new equity capital for some 1,200 U.S. companies, up from $16 billion in '82 and $4-5 billion years in the 60's and 70's.
- Venture capital reached $2 billion in '83, up from $1.4 billion last year and $867,000 in '81 and $661,000 in 1980. There was no venture capital to speak of in the 70's.

And all this has occurred at the same time the thrift industry has made a remarkable recovery from the serious problems it was encountering three years ago and while Citicorp, the parent of the world's largest bank, has experienced record profits the past two years.

The capital our industry helps raise will fuel a superior rate of growth for U. S. business for a number of years to come. There is no comparable situation in Japan, Germany, England or France.

In the debate that has ensued over the complex issues your Committee has been dealing with during the past three years certain expressions are heard time and again such as "if it isn't broke, don't fix it" and "level playing field." And then there is the term "deregulation" which has acquired a unique power to preempt debate. Whatever is proposed in the name of deregulation is presumptively worthy of enactment. Although these expressions have become hackneyed, they can be useful if used sparingly and properly understood.

For example, what is wrong in the principle of separation of commercial and investment banking embodied in the Glass-Steagall Act (i.e., "what's broken") to require drastic legislative changes (i.e., "the fixing") of the kind proposed in the bills before the Committee? If there is some serious problem affecting large segments of the public by reason of continued adherence to Glass-Steagall principles would you not be hearing from those the Act was designed to protect? The only proponent for change is the banking industry, principally the large financial center banks which continually seek new non-banking powers. We know of no demand for change originating with the professionals who manage the billions of dollars in pension funds, or the corporate treasurers or the millions of individual investors our members serve. Nor are we aware of any great demand for changes from bank depositors or customers of other banking services. I personally have heard corporate treasurers express serious concern about any evolution in our financial markets that would result in their dependency on a single source of supply for their short and long term credit requirements. In our opinion, if the Glass-Steagall Act needs any "fixing" it should be to strengthen it.

You must be tired of hearing the term "level playing" field, a convenient shorthand expression to describe what everyone agrees is essential -- an economic environment in which all participants in a given marketplace compete on equal terms. Since we doubt that fair competition can ever be achieved in the securities business if depository institutions with a trillion dollars in federally-insured deposits and numerous other competitive advantages derived by law are allowed to compete with non-depository institutions, we are increasingly skeptical that a "level playing field" on which banks and securities firms compete can ever be legislatively achieved.

And then there is the rubric "deregulation" which Chairman St. Germain has described as a tonic "cure-all for everything from in-grown toenails to sagging balance sheets." Before responding to those who seek to abandon Glass-Steagall principles under the guise of "deregulation" we urge you to review the history of the disastrous events which led to its enactment. That history, briefly related in prior SIA testimony, is appended to our statement (B).

The Pending Legislation

We now comment on the legislative proposals which are the subject of these hearings and include also comments on the Treasury proposal. For convenience we shall refer to them as Garn (S. 2181), Proxmire (S. 2134) and Treasury (S. 1609). For the most part our comments will be limited to the provisions of these bills that particularly affect the securities industry.

All three proposals have a core provision that would allow bank holding companies to establish securities affiliates which could underwrite and deal in presently ineligible revenue bonds and underwrite, distribute and sell the securities of mutual funds. In addition, the Garn and Proxmire bills allow the securities affiliate to underwrite and deal in mortgage backed securities. If a bank holding company elects to acquire or form a securities affiliate, within one year thereafter certain securities activities which may now be conducted in the bank would have to be transferred to the affiliate. These include underwriting and dealing in government and municipal securities and providing brokerage services to the extent presently allowed under section 16 of the Glass-Steagall Act (12 U.S.C. 24).

All three proposals make important changes in section 4(c)(8) of the Bank Holding Company Act (BHCA) which presently allows such holding companies to acquire the shares of a company engaged in activities "so closely related to banking or managing or controlling banks as to be a proper incident thereto." In determining whether to allow a bank to engage in any such activity the Federal Reserve Board is now mandated to consider various factors, e.g., whether the expected benefits to the public outweigh the possible adverse effects "such as undue concentration. . ., decreased or unfair competition, conflicts of interest, or unsound banking practices." These latter tests are eliminated by all three bills as well as the "proper incident thereto" requirement in determining future permissible activities for bank holding companies. The Treasury and Garn bills specifically allow bank holding companies to engage in insurance underwriting and brokerage, but Proxmire retains the existing prohibitions on such activity.

The Treasury and Proxmire bills contain provisions designed to close the "nonbank bank" loophole which has permitted firms not engaged in banking to acquire a depository institution without becoming a bank holding company. The Garn bill confirms the loophole and exempts from the definition of "bank" in the BHCA "consumer banks" defined as depository institutions that do not make commercial loans.

Both the Treasury and Garn proposals grant new powers to savings and loan holding companies commensurate with those allowed bank holding companies, including the acquisition or formation of securities affiliates authorized to engage in the same activities and with the same powers conferred on bank holding company securities affiliates. Proxmire contains no similar provision and would impose some new restrictions on unitary savings and loans holding companies.

The Garn bill, recognizing concern for concentration of economic power, prohibits any bank holding company with a bank or banks having consolidated deposits exceeding 0.30 percent of all domestic deposits from combining with companies engaged in otherwise permissible insurance, securities or real estate activities if the investment of the holding company in any one such activity exceeds 25 percent of the consolidated capital of the holding company.

The Proxmire bill, recognizing the need to do so, affirms the application of the Glass-Steagall Act to state chartered non-member banks.

The SIA Position On The Pending Legislation

Our industry's support of the separation of commercial and investment banking has been consistent and unwavering during the 50 year existence of the Glass-Steagall Act. Almost from the date of its enactment, however, our nation's largest banks have chafed under the restraints the law has imposed preventing them from engaging in the securities business. Efforts to repeal or modify the separation of our businesses mandated by the 1933 Act began as early as 1935 and continue to this day with ever increasing intensity. Always the request for change in the law has come from the banks. We cannot recollect a single instance where modification of the law has been sought by the securities industry even though the restraints are mutual, binding our members as well as the banks.

A close analysis of the three bills under discussion leads inescapably to the conclusion that at their core they eviscerate and nearly repeal the Glass-Steagall Act and in our opinion unwisely modify the BHCA. For example, as we understand the proposals, they permit, with one exception, the combination of activities within a holding company structure of the kinds pursued by banks, thrifts, securities firms, mutual funds, insurance underwriters and brokers, real estate developers and brokers and any other activity the Federal Reserve Board determines "to be of a financial nature." The exception is that underwriting and dealing in corporate securities may not be included in the activities mix. But it is safe to predict that once the separation barrier is breached to the extent contemplated by these proposals the desires of the large financial center banks for corporate underwriting powers will prove irresistible. Thus, although there are provisions in all three bills we could support, their overall erosive effect on the separation of commercial and investment banking leaves us no choice other than to oppose their enactment.

The Separate Subsidiary Concept

The idea of granting banks additional securities powers provided such activities are carried on in a separate securities affiliate of a bank holding company into which the affiliated bank would have to transfer its presently authorized underwriting activities was first advanced by Secretary Regan in testimony before this Committee on October 19, 1981. In describing his proposal, the Secretary made the following comments:

> Our proposed bank holding company securities subsidiary would have the same tax treatment as an independent securities firm, the same regulators and the same access to outside financing and outside customers. In contrast, leaving securities activities submerged within the corporate structure of a commercial bank . . . would afford the bank several advantages in the securities business. The bank securities activities would have preferential tax treatment, particularly as regards the carrying of securities and inventory; they would be regulated by the federal bank regulatory agencies for which securities activities are only a limited aspect of bank business; they would have access to financing based on the cost of the bank's insured deposits; and they would have opportunities for the non-long arms' length linkage of traditional bank services to the securities business of the bank. There are too many inequalities here to satisfy the goal of equal treatment for all financial institutions doing the same kinds of business."

In a letter to you, Senator Garn, dated November 12, 1981, the SIA gave a qualified endorsement to the concept of a separate subsidiary, but only if the Congress decided to grant additional securities powers to banks. At the risk of being repetitious we repeat our view that it is contrary to the public interest to grant such additional powers to banks. However, the separate subsidiary approach is a preferred alternative to having the securities activities conducted in the bank.

When the SIA testified February 12, 1982, before this Committee's Subcommittee on Securities we analyzed the concept of a separate securities affiliate and what principles should be followed and enacted into law that would create a fair competitive environment and proper insulation of the securities activities from the bank holding company complex. In Appendix C to this statement, we restate and discuss those principles. We also include the research memorandum we presented at that time to illustrate the problem of bank tying arrangements in Appendix D.

The presumed advantages of a separate securities affiliate are two-fold - to protect the safety and soundness of the bank and the banking system and to provide an environment in which bank securities affiliates and other securities firms can compete on fair and equal terms. We are skeptical that either objective can be fulfilled. The first objective assumes that a bank could allow a securities affiliate to fail without attempting its rescue, or that such a failure could occur without substantial consequential harm to the affiliated bank. Mr. Walter Wriston, Chairman of Citicorp, shares our skepticism. Commenting on the concept of a separate securities affiliate in testimony before your Committee on October 29, 1981, he stated:

> A holding company is probably the clumsiest, most expensive way that exists to operate any business. We have only gone to a holding company in order to comply with the law, and gain some flexibility by so doing. But it is a very poor way to operate. For example, it is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way.
>
> So I don't see any benefit in getting a separate subsidiary for new businesses. . . I don't see any benefit from it myself.
>
> I would go just the other way. If the National Bank Act was amended to say that everything a bank holding company can do, the National Bank can do, I'd be extremely happy. It would simplify administration and would make it perfectly clear to the customer that our $7 billion capital is behind everything that we do. (Emphasis supplied).

Chairman Volcker in testimony before this Committee earlier this year in Salt Lake City stressed once again that banks still play a unique and critical role in the financial system and the economy and the alertness all should have for their continuing stability and impartiality:

> We also believe that these concerns must, to a degree, encompass business organizations of which banks are a part -- that is, bank holding companies -- for the basic reason that a bank or depository institution cannot be wholly separated from the fortunes of its affiliates and from the success or the failure of their business objectives.

In his study of the events which led to the enactment of the Glass-Steagall Act Professor Nelson Peach concluded that it did not seem possible to prevent by legislation the serious abuses which grew out of the mixing of the commercial and investment banking. Peach's major concern was the temptation that banks would have to aid their unsound affiliates even if doing so threatened the bank's own solvency. Commenting on the situation that prevailed prior to the Glass-Steagall Act he wrote:

> Since, when the securities were sold, the public had been persuaded that the bank and affiliate were parts of the same organization, the bank could not escape responsibility for the activities of its affiliate when the securities began to decline in value after the stock market crisis of 1929. It became necessary for banks to assist their affiliates because they were aware that any diminution in the good will of their affiliates would bring with it a corresponding diminution in their own. This is the chief difficulty in the affiliate system. . .
> Peach, Security Affiliates of National Banks, p. 142.

Conclusion

Most of the controversy that has developed in recent years over the appropriate roles of providers of such financial services as banking, savings, securities and insurance finds its origin in administrative and judicial interpretations of the various laws enacted to define the powers of the different kinds of providers. This is particularly true of the Glass-Steagall and Banking Holding Company Acts. Creative lawyers, representing financial institutions bent on exploring the outer limits of their statutorily derived powers, have exploited ambiguities or "loopholes" in these and other laws to add to those powers. Frequently, they have been aided by friendly regulators inclined to interpret the law in accord with their view of what Congress should do, not what it has done. In the process the Congress is criticized for not exercising its legislative powers to keep the law abreast of what is occurring in the marketplace. We are told the Glass-Steagall and Bank Holding Company Acts are outmoded. Simply because these laws are respectively 50 and almost 30 years old is no reason to discard them. Rather, there is much more reason to keep them because our financial systems are working so well. In our testimony, we obviously have come down strongly in full support of Glass-Steagall as it now stands. Indeed, given the loopholes recently opened up by various bank regulatory agencies, we favor a strengthening and clarification of this legislation since the precedent of 50 years of experience is being ignored today by bank regulators.

SIA's greatest concern about the weakening of Glass-Steagall is that banks will easily be able to use their dominance in the short-term financing of corporate and government entities as a lever to take over the alternative longer-term forms of financing, including the underwriting of new equity securities and long-term debt. In our view this would lead to an excessive concentration of economic power as well as unacceptable conflicts of interest that are sure to haunt us in the future as they have in the past.

A few members of the Securities Industry Association now own or have expressed interest in owning "non-bank banks," as they have been somewhat pejoratively called. A form of such bank is provided for in the Garn bill. We of course believe that the immediate need is for a full and thoughtful review of Glass-Steagall and other relevant laws. If Congress, despite our view that the historic separation required by Glass-Steagall should continue, decides that bank securities powers should be expanded, then it should perhaps consider whether some banking powers, perhaps consumer-oriented ones, should be made available to institutions outside of banking such as securities firms.

However, we are concerned that each move by aggressive banks entering the securities business and aggressive brokers entering some form of deposit banking would lead to the eventual erosion of the basically sound principles of Glass-Steagall. It is a road that leads us right back to what got this country in trouble in the late 1920's.

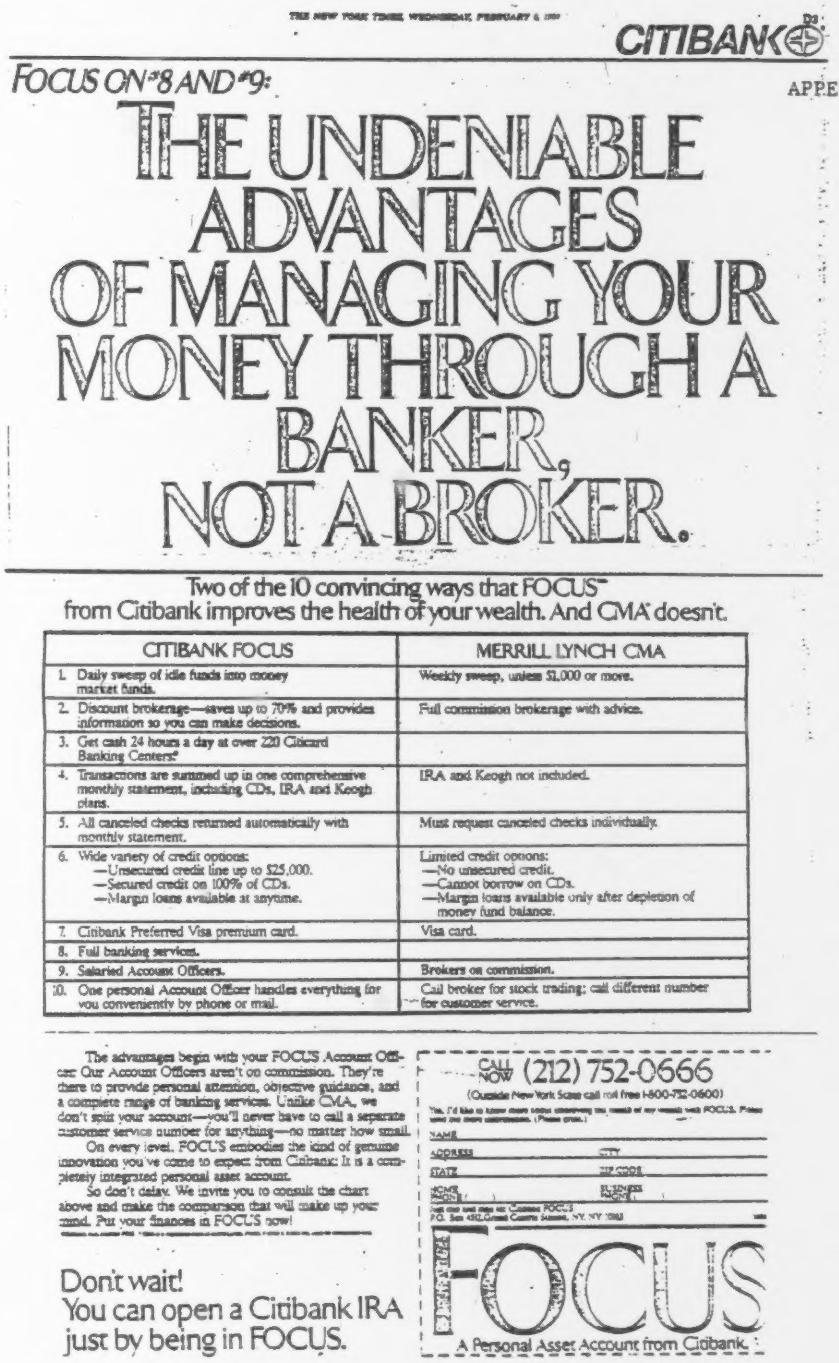
The need to resolve the confusion and uncertainty now existing with respect to the powers of the various providers of financial services is a task only Congress can ultimately and intelligently resolve in the national interest. The numerous federal and state regulators, and the state legislatures, which are largely responsible for the prevailing confusion, cannot be expected to fashion workable solutions.

A long range solution having broad public support will take time to develop. We have repeatedly expressed our view that the right answers will be found only after a comprehensive review of Glass-Steagall and the other major statutes which up to now have determined and shaped our financial marketplace. Only following such a review, which we urge you to undertake, will we be able to decide the statutory structure that will best serve our national interests through the end of this century and into the next. Pending such a review, Congress should act now to insure the maintenance of a status quo which, to the extent possible, deals fairly and equitably with the various segments of the financial services industry and the individual participants therein. No one should be allowed to benefit by or exploit a status quo mandated by statute.

Various moratorium proposals have been introduced in both the Senate and House designed to maintain the status quo in the marketplace, including S. 1532, drafted by the Federal Reserve Board. We again recommend the enactment of such legislation, with an expiration date reasonably fixed to allow Congress to undertake the review and study we have recommended.

We thank you for this opportunity to have appeared before you.

APPENDIX A



THE NEW YORK TIMES, WEDNESDAY, FEBRUARY [illegible]

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4. Transactions are summed up in one comprehensive monthly statement, including CDs, IRA and Keogh plans.	IRA and Keogh not included.
5. All canceled checks returned automatically with monthly statement.	Must request canceled checks individually.
6. Wide variety of credit options: —Unsecured credit line up to $25,000. —Secured credit on 100% of CDs. —Margin loans available at anytime.	Limited credit options: —No unsecured credit. —Cannot borrow on CDs. —Margin loans available only after depletion of money fund balance.
7. Citibank Preferred Visa premium card.	Visa card.
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The advantages begin with your FOCUS Account Officer. Our Account Officers aren't on commission. They're there to provide personal attention, objective guidance, and a complete range of banking services. Unlike CMA, we don't split your account—you'll never have to call a separate customer service number for anything—no matter how small.

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APPENDIX B

A Chapter From Banking History

"Those who cannot remember the past are condemned to repeat it", said the philosopher George Santayana. It is difficult, even a little disagreeable, to recall now the disasters of the 30's and the chain of events in the 20's which brought them about. Yet the effort must be made, for any reliable prediction of the future must be firmly rooted in the experience of the past. Indeed, had the commercial banks heeded warnings based on past experience they would have recognized, long before 1929, the dangers inherent in their participation in the investment banking business.

As early as 1911, the Solicitor General of the United States had pointed out, "It is neither banking nor an incident of banking to invest the funds of the bank in another business, in any manner or to any extent."[1/] In holding that the National City Company's operations violated federal and state law, he had stated that combining banking and non-banking functions in the same or affiliated organizations created the risk of involving all of them "in a common disaster," and that, even if successful, such combination "would mean a union of power in the same hands over industry, commerce and finance with a resulting power over public affairs" which would clearly be against the public interest.[2/]

In 1913, after extensive hearings, the House Committee on Banking and Currency, the Pujo Committee, had specifically emphasized the desirability of divorcing investment banking from commercial banking.[3] And in 1920 the Comptroller of the Currency had cautioned: "The business of legitimate banking is entirely separate and distinct from the kind of business conducted by many of the 'securities corporations,' and it would be difficult, if not impossible, for the same set of officers to conduct safely, soundly, and successfully the conservative business of the national bank and at the same time direct and manage the speculative ventures and promotions of the ancillary institutions."[4]

The large commercial banks did not listen. The interest of the many in having fundamentally sound and well regulated banking was flouted in favor of the short-run private advantage to a few. The temptations were too great. Closing their eyes to the conflicts of interest and yielding to the temptations to speculation about which they had been warned, these banks, with their vast capital, achieved a meteoric rise to dominance in investment banking. As Judge Harold R. Medina observed in the landmark opinion that has become the definitive text on investment banking (United States v. Morgan, 228 F.Supp. 621, 644-645:

> ". . .The economic power of these huge aggregations of capital vis-a-vis the relatively small capital of issuers was a factor of no mean significance in the period just before the great depression. There was an additional leverage in the multiplicity of banking functions which could be placed at the disposal of issuers. Added to this was the vast influence and prestige which must have made itself felt in a variety of ways. Issuers were dependent upon these

> great banking institutions in a way which finds no parallel in the relations between issuers and investment bankers in the period subsequent to the passage of the Banking and Securities Acts. . . .
>
> * * * *
>
> ". . .(T)hese great banking institutions and their affiliates were doing a huge investment banking business, and they were using the money of their depositors as well as their own resources to underwrite one security issue after another."

This unique power and prestige were exploited in every possible way to squeeze out investment banking competition. By abusing their legitimate fiduciary functions of lending and investing "other peoples" money such banks were in an unequalled position to build up their underwriting activities, which in turn contributed new customers for their commercial banking and trust department services.[5/] Not many who could possibly be customers of either the banks or their securities affiliates were overlooked. For example, lists of depositors and stockholders were made available to the securities affiliates.[6/] These prospects, when subjected to high pressure sales methods, proved a fruitful source of new business to the affiliates.[7/] Employees of the banks proved another such source.[8/] And, taking advantage of a correspondent banking system that even today provides the same opportunities for abuse by a bank which is also a securities underwriter, many of these financial giants used the small country banks that trusted them for investment advice as "a good dumping ground for second or third grade securities."[9/] Senator

Brookhardt noted that these securities had "depreciated so much that they closed several thousand banks."10/

By 1929 such tactics had enabled certain great commercial banks to reach the pinnacle of their power and influence over the capital markets of the nation. A statement submitted by J.P. Morgan & Co. in 1932 to the Senate Banking and Currency Committee spoke no more than the sober truth:

> "The great commercial banks, directly or through their affiliates, have in the past 20 years or thereabouts to a large extent occupied the field of capital issues, purchased and absorbed some private issuing and distributing houses, and by their competition driven others out of business or restricted their opportunity for profit and therefore their resources."11/

Figures submitted to the Senate Committee in February 1931 by Charles E. Mitchell, then President and Chairman of the Board of both the National City Bank and the National City Co., revealed that, in the four-year period from 1927 through 1930, the originations of new issues by all banks - national banks, commercial banks, trust companies, and various bank affiliates - had increased from 22% of total originations in 1927 to 44.6% in 1930. The share of private bankers, i.e., investment bankers, had decreased correspondingly from 78% of total originations in 1927 to 55.4% in 1930. Similarly, the banks and allied institutions had increased their share in participations from 36.8% in 1927 to 61.2% in 1930, while that of the investment bankers had decreased correspondingly from 63.2% in 1927 to 38.8% in 1930.

Moreover, this growth in underwriting size and power had become increasingly concentrated in the securities affiliates of the relatively few banks that were actively interested in the securities business. While commercial banks on the whole were approximately doubling their share, these affiliates nearly tripled their total share of the securities business during this period, from 12.8% of originations in 1927 to 39.2% in 1930, from 20.6% of participations in 1927 to 54.4% in 1930.[12/]

When the depression struck, however, such banks and their underwriting affiliates suffered a dramatic and tragic reversal of fortune, particularly tragic for the hundreds of thousands of people who had entrusted their money to them. Even the banks came to recognize, if only temporarily, that the very combination of commercial and investment banking functions that had enabled them to dominate American finance was to a great extent responsible for their enfeebled financial condition, and certainly for that of their depositors and the investing public at large.

The hearings held by the Senate Banking and Currency Committee from 1931 to 1934 disclosed example after example of shockingly reckless and dangerous banking practices engendered by the widespread activities of certain banks through their securities affiliates, in both the underwriting and distribution of securities, and also demonstrated how directly these activities had imperiled the position and soundness of many of the banks concerned. These hearings left no doubt that the primary banking functions of serving as a depository, as a trustee, as an investor of deposited funds, and as a lender, all could be and often had been abused by some banks that also sought to engage in the underwriting and distribution of security issues.

When certain securities affiliates had tottered on the brink of ruin as a result of the remorseless deflation which began in 1929, the parent banks, naturally fearing that the failure of the affiliate would irreparably damage the bank's own credit and standing, felt forced to go to their aid with financial assistance in the form of either loans to the affiliate or purchases from the affiliate's inventory of unsalable or greatly depreciated securities. The loans in many cases were excessive or were secured by inadequate collateral and subsequently entailed huge losses.13/ Instances also came to light during the hearings of trust accounts which had been loaded with unsound securities, some of them partially in default. Such securities had been purchased from the bank or trust company's affiliate, often at a handsome profit to the affiliate, a gross violation of the fiduciary relationship.14/

The collapse of a number of major banks demonstrated how their involvement in the business of investment banking had played a significant part in undermining their financial position; individual bank losses in connection with such activities were measured in the tens of millions or more.[15]

The magnitude of the individual and institutional disasters caused, at least in part, by the involvement of banks in the securities business made Senator Carter Glass exclaim, in the course of the hearings, "The public cannot conceive of the harm done by these affiliates."[16] The enactment of the Glass-Steagall Act, and the preservation of its guiding principles against attack, was the response of Congress to this sorry record. The then President and Chairman of the Board of the Chase National Bank, Winthrop W. Aldrich, a distinguished banker and lawyer and subsequently Ambassador to Great Britain, said in a statement submitted to the Senate Banking and Currency Committee in November, 1933:

> "[My] experience as a bank official, coupled with the testimony which was presented to your committee in February of this year had convinced me that many of the abuses in the banking situation had arisen from failure to discern that commercial banking and investment banking are two fields of activity essentially different in nature. I came to believe that while it was essential that there should be coordination between these two types of banking, such coordination could best be protected from abuse and thus enhanced in usefulness through absolute separation of interest between the two fields. . . .
>
> * * * *
>
> "The system itself which permitted overlapping of function and interlocking of

> interest between these two types of banking has been responsible for much that the public now condemns."

Mr. Aldrich emphasized: "The commercial bank's credit function is very definitely governed by its responsibility to meet its deposit liabilities on demand. It must not seek excessive profits by taking undue credit risks and it cannot wisely tie up its funds in long-term credits however safe they may be." On the other hand, he pointed out, when long term credit is required, the services of the investment banker are needed to "take speculative risks of a sort unsuitable to the commercial bank in providing capital funds for new and promising enterprises." With every new issue the investment banker "takes the risk that the public may not readily absorb the new securities which he brings out and that his own capital may be tied up for a long time."

The Glass-Steagall Act was praised by Mr. Aldrich not only for preventing the banks from undertaking risks that they could not and should not assume but also for eliminating the possibilities of abuse inherent in a union of the underwriting and commercial banking functions. The commercial banks, he maintained, "should not be in a position to exert any pressure whatever arising out of a dual financial interest." He specifically recognized that it was inconsistent with the bank's duties as lender, as trustee, as depository and as advisor to its customers for it also to engage in the securities business. By way of illustration, he said:

> "It is perfectly proper, for example, that commercial banks should lend to investment bankers, on short term, funds necessary to carry a new issue of securities while it is in the process of being marketed. Such a loan, always secured by collateral and carefully scrutinized by the commercial bank, performs an essential service. The commercial bank or banks making such a loan, however, should be absolutely free from interest in the issue, and immunized from possible influence arising from interlocking interests with the investment bankers participating in it."

Mr. Aldrich concluded:

> "In considering legislation aimed at prohibiting practices contrary to the public interest, it is impossible to draw a distinction between the careful and conscientious banker who would never consciously permit his influence to be misused or his allegiance to be divided, and the banker, who, through recklessness or even because of his private interest, might exercise his influence improperly, if opportunity is permitted to exist.
>
> * * * *
>
> "The wisdom of effecting a clear differentiation of function and separation in interest between commercial banking and investment banking was recognized in the Glass-Steagall Bill, passed last June and now known as the Banking Act of 1933. The history of that Act and its general provisions indicate a clear intent on the part of Congress to effect, once and for all, a complete separation between commercial banks and investment bankers."17/

The Glass-Steagall Act, passed in 1933, removed all but limited securities activities from the reach of the commercial banks, in explicit recognition that such concentration of economic power in banks had precipitated and exacerbated the crash and subsequent depression. Accordingly, an independent, responsive, professional, nation-wide broker/dealer community, severed from bank affiliation by the Glass-Steagall Act, emerged and grew, developing competitively under the rigorous demands of private citizens, government and business. The United States broker/dealer community, overseen by one of the federal government's most watchful and effective regulatory agencies, the Securities and Exchange Commission ("SEC") services our nation's securities needs in the most efficient capital market in the world. One might ask why we should tinker with this highly complex system, essential to our economic well being, when by all standards it is currently functioning very well.

1/ This quotation appears in an opinion dated November 6, 1911 that Solicitor General Frederick W. Lehmann submitted to Attorney General Wickersham. It was quoted at Hearings fore the Senate Committee on Banking and Currency pursuant to S. Res. 84, 72d Cong., 1st and 2d Sess., p. 2029. These Hearings will be cited hereafter as 72d Cong. Hearings.

2/ *Id*., at p. 2030. Oddly enough, no action was ever taken, although Attorney General Wickersham apparently concurred in this opinion. *Id*., at p. 2043.

3/ Hearings before Senate Committee on Banking and Currency pursuant to S. Res. 56 and 97, 73d Cong., 1st and 2d Sess., p. 3978 (hereinafter cited 73d Cong. Hearings), where the Honorable Winthrop W. Aldrich stated: "The thought, however, that the overlapping of interest as between commercial banking and investment banking might be subject to grave danger was not in any sense a new one. The hearings and the report of the Pujo Committee dated February 28, 1913, had pointed out the desirability for such changes." For the Pujo Committee Hearings and Report, see Hearings before a Subcommittee of the House Committee on Banking and Currency pursuant to H. Res. 429 and 504, 62d Cong., 2d Sess., part 28 of which contains the Committee report.

4/ Quoted at Hearings before a Subcommittee of the Senate Committee on Banking and Currency pursuant to S. Res. 71, 71st Cong., 3d Sess., p. 1067. These Hearings will be cited hereafter as 71st Cong. Hearings.

5/ See statement of Charles E. Mitchell, id., at p. 318; also 73d Cong. Hearings, supra note 3, p. 4388, where Robert O. Lord, in his testimony regarding the Guardian Detroit Group, stated that one reason for the acquisition of Keane, Higbie & Co. was that "contacts with some of their customers, helped in securing business for the banks and trust companies;" and id., at p. 4789, where Frank W. Blair, formerly president of the Union Trust Co. of Detroit and chairman of the board of the Guardian Detroit Union Group, Inc., stated in a letter that Mr. Higbie had urged the acquisition of Keane, Higbie & Co., as one "which would be able to contribute trusteeships from the companies they financed, bank accounts from industries with which they were in close relationship, and lastly as one which would contribute very substantial earning power under conditions as they then prevailed."

6/ 72d Cong. Hearings, supra note 1, pp. 2013-15, 2019, 2021.

7/ Id., at pp. 2019-20. Customers of the National Bank of Commerce, Detroit, for example, "complained that they made the loan in order to buy certain securities recommended by an officer of the bank or securities in which this bank or some affiliated institution was directly or indirectly interested." See 73d Cong. Hearings, supra note 3, p. 4495.

8/ See 72d Cong. Hearings, supra note 1, pp. 1872-77, for details of an employees' stock purchase plan under which employees of the National City Bank were persuaded to subscribe to the purchase of 20,000 shares of bank stock at from $200 to $220 per share _after_ the crash in October and November 1929. The employees were held strictly to their subscription contracts despite a decline that brought the price on such stock to $40 by 1933. See also 73d Cong. Hearings, _supra_ note 3, p. 7987, for a discussion of the sale by Guardian Securities Company of Cleveland of about 2,000 shares of a 15,000 share issue of Inland Investors, Inc., stock to employees of its affiliate, the Guardian Trust Co., on the partial payment plan at $52.50 per share. The market price subsequently declined, reaching about $9 per share at the time of the investigation.

9/ 71st Cong. Hearings, _supra_ note 4, p. 502.

10/ 72nd Cong. Hearings, _supra_ note 1, p. 2221.

11/ 73d Cong. Hearings, _supra_ note 3, p. 953.

12/ 71st Cong. Hearings, _supra_ note 4, p. 299.

13/ 73d Cong. Hearings, _supra_ note 3, pp. 7996-97, 8132, 8140, 8256-57.

14/ At one point, Ferdinand Pecora, counsel to the subcommittee, quoted a memorandum to the effect that a "First Detroit Co., which is one of the investment or security affiliates or units of the Detroit Bankers Co., acquired certain of these Watson Realty Co. mortgage bonds at 93 1/2, transferred them to the Detroit Trust Company the same day at 95.759 and that the Detroit Trust Co. sold those mortgage bonds, some of them at par and some at 97, to various trusts committed to its care." Mr. William J. Thomas, Treasurer of the Detroit Trust Co., testified: "I know that many sales were made of that nature." 73d Cong. Hearings, supra note 3, pp. 5295-96. See also, id., at p. 5300-5301. On one occasion, although some of the underlying mortgages were already in default, this trust company sold mortgage participations to trust accounts managed by it. See also p. 5353.

"The Guardian Trust Co. in its capacity as trustee, has violated its fiduciary relationship in more than one instance by burdening trust estates over which it had discretionary investment powers, with securities in which the bank realized a profit by the expedient of passing securities through its bond department, and subsequently to its estates." Id., at p. 7986. See id., pp. 8063-8068, for other instances where there were violations of a fiduciary relationship by a bank whose trust department bought bonds from its bond department.

15/ For example, in the failure of the Guardian Detroit Union Group with a deficit of nearly $15,000,000, nearly $6,500,000 was attributable to securities losses in their two largest affiliates. Id., at pp. 4701-02, 4981-83. In October 1933, the Union Cleveland Corporation, a securities affiliate of the parent Union Trust Company (Cleveland), had a deficit of nearly $2 million, completely wiping out its surplus and almost all of the stockholders' equity; the depositors of the parent Trust Company received only 40 cents on the dollar when it closed. Id., at pp. 8132, 8140, and 8256-57. The Guardian Trust Company (Cleveland) had losses of nearly $30 million, partly occasioned by its "engagement in practically every type of business along with the banking business", which brought about a potential deficit of about $12 1/2 million; in February 1932, a year before its closing, the bank was hopelessly insolvent. Id., at pp. 7982-83.

The whole era is best summed up in the colloquy between Albert H. Wiggin, former president of the Chase National Bank, Ferdinand Pecora, counsel to the Senate Committee, and Senator Couzens of Michigan, just after Mr. Wiggin's testimony revealed that Chase Securities Corporation had suffered realized and unrealized losses of over $120,000,000 --nearly six times the dividends paid out during its entire existence since 1917: Senator Couzens--"Would you consider that a very good record?" Mr. Wiggin--"Oh I think that is a very unfortunate record, but this is world trouble and we are probably better than the average. There are some security companies that were wiped out, many of them." Mr. Pecora--"Do you think this record vindicated the judgment of the authorities of the bank when through the securities affiliate they engaged in issuing securities and underwriting them, trading in them?" Mr. Wiggin--"The figures do not verify that; no, sir." Id., at pp. 2406-07.

16/ Id., at p. 4027.

17/ 72d Cong. Hearings, supra note 1, pp. 3977-3981.

APPENDIX C

Securities Industry Association Statement of Principles Regarding Separate Securities Affiliates of Bank Holding Companies

In developing an affiliate structure that would create a fair competitive environment and proper insulation of the securities activities from a bank holding company complex, SIA believes the following principles must be followed:

1. Only a separately capitalized, arm's-length subsidiary of a bank holding company ("securities affiliate") should be permitted to underwrite and trade in municipal revenue bonds (not including industrial revenue bonds or special assessment bonds). The capitalization of the securities affiliate should not unfairly benefit from affiliation with the bank holding company complex (e.g., access to lower cost capital and federally insured deposits).

2. The securities affiliate should be the only member of the bank holding company family to engage in securities activities. It should take over all securities activities presently carried on by members of the bank holding company complex. All securities activities should be defined to include all those which if carried on by a securities firm would be subject to regulation by the Securities and Exchange Commission as well as all activities involving exempt securities. If the securities affiliate is to be an equal competitor, its regulatory status should be the same as that of a broker-dealer. All of the securities laws should apply with supervision in the Securities and Exchange Commission.

3. No member of the bank holding company complex should be allowed to use its assets or business relationships to assist the securities affiliate in its securities activities. Creation of the affiliate alone will not provide the required isolation. Many of the pre-Glass-Steagall abuses involved bank security affiliates. All financial transactions, purchases and sales of products and services as well as credit transactions, between the securities affiliate and the bank holding company complex should be prohibited. The principal advantage of a bank is as a source of liquidity, not just money at a better price, but money in times of high demand at any price. Favoritism in the availability of funds would be impossible to police. The securities affiliate should go elsewhere for its credit and customers. (The problem of reciprocal dealing between the securities affiliate of one bank holding complex with members of another bank holding company complex in return for similar dealings must also be addressed.) Only in this way can the securities affiliate be separated from the privileges and advantages of bank members of the complex. Also, a securities affiliate should be barred from dealing with customers of other members of the bank holding company complex in ways which could involve the shifting of risks to and from the securities affiliate.

4. Deposits should be completely insulated from the risks assumed by a securities affiliate and should not directly or indirectly become of benefit to a securities affiliate. Federal

insurance of deposits is a significant advantage for commercial banks which contributes to public confidence in and the stability of the banking system.

5. The tax treatment of securities affiliates and of banks which are allowed to continue securities activities should be identical to that of broker-dealers and should be provided for specifically in any proposed legislation dealing with these matters. (The most significant advantage is the deductibility of the carrying costs of municipal bonds.) Eliminating the present bank advantage would enhance Treasury revenues, but the securities industry would accept, although it does not seek, the same advantages as a means of achieving equality.

6. The Bank Holding Company Act should be amended to forbid a securities affiliate from participating in a financing in which any member of the bank holding company complex is participating (e.g., as supplier of a letter of credit or short term financing or acting as bond trustee), and vice versa. A significant unfair advantage for a bank is its ability to tie its credit facilities to its underwriting services. Existing prohibitions against tying arrangements in the Bank Holding Company Act (12 U.S.C. Sec. 1272) are inadequate to prevent unfairness. All joint marketing and collaborative efforts involving a securities affiliate and another member of its bank holding company complex should be absolutely barred. The abuse of linking credit facilities to underwriting services (whether between two bank departments or a securities affiliate and a holding company

complex member) should be eliminated, regardless of whether the Administration's proposal becomes law. The use of credit leverage is unfair and the roles of supplier of credit and managing underwriter are in direct conflict.

7. If the securities affiliate is to operate under its own authority and by its own skill, it should not benefit from customer and other valuable data constantly flowing into and developed by its affiliated banks. Therefore, a "Chinese wall" should be erected between members of the bank holding complex and the securities affiliate. Officers and employees in common should not be permitted and directors in common allowed only to the extent permitted in similarly sensitive situations under the Investment Company Act. Exchange of non-public information of a material nature should not be permitted.

8. A securities affiliate should not be permitted to trade on identification with the bank holding company complex. It is clear from the experiences with real estate investment trusts that the public can easily be confused or be misled into believing that bank credit is behind the operations of an affiliate. Such misunderstanding should be avoided to insulate federally insured bank funds and to prevent an unfair benefit of credit identification from being conferred upon the affiliate. A securities affiliate should have a separate and distinguishable name and not be advertised as associated with the bank affiliate, directly or indirectly so as to suggest credit responsibility in

the public's mind. For the same reason the securities affiliate should not share premises with any member of the holding company complex. Also, since a securities affiliate could be unfairly subsidized by sharing space or operational facilities, such arrangements should not be allowed. The securities affiliate should bear its own costs and expenses.

9. If new underwriting powers are to be granted to bank holding companies or banks, appropriate powers in the field of banking should be granted to securities firms. If competition is deemed to be enhanced by expanded securities powers for banks or bank holding companies, we believe that members of our industry can add significantly to competition in banking and should have the opportunity to do so. To what extent such powers should be given to members of the securities industry depends upon the degree to which Glass-Steagall principles are abandoned. Should, for example, Title III of S. 1720 or an equivalent law be enacted the appropriate enlargement of opportunity for securities firms may well be full powers of a national bank free of all geographic restrictions for all existing securities firms as of the date of enactment. (Since the banking community is already well-established with offices and correspondent bank relationships, to be effective the grant of full powers to securities firms should be free of geographic limitations.)

10. A carefully phased timetable for institution of any such changes should be worked out in the interest of stability.

In order to create fair and equitable competition and opportunity for all, any proposed legislation should deal with all matters relating to securities activities of banks and bank holding companies, including the equalization of tax and regulatory treatment, and commercial banking powers for securities firms.

Summary

It is clear that the matters under discussion are complex and difficult. No doubt many will differ with the principles SIA has identified as essential to allowing bank holding companies to have securities affiliates and will question their necessity. That is precisely why we maintain that a comprehensive review of Glass-Steagall and of the applicability of the securities laws to banks securities activities are an essential prerequisite for legislative action.

APPENDIX D

RESEARCH MEMORANDUM CONCERNING TIE-INS OF BANK CREDIT FACILITIES TO SELECTION AS MANAGING UNDERWRITER OF MUNICIPAL HOUSING REVENUE BOND ISSUES

The attached tables illustrate the involvement of three major commercial banks in letter of credit put bond transactions. In such transactions a major bank provides a letter of credit to enable an issuer to sell a 20-year plus bond which a bond holder can tender back to the agency at part at the end of, say, five years and annually thereafter. Such a right to "put" a bond early lowers the interest rate on the bond substantially. Only large commercial banks have the financial strength to bear the enormous risk of such a repurchase obligation. These charts are based on data derived from the Bond Buyer and Official Statements relating to the particular bond issues. The transactions are single family and multi-family housing revenue bond offerings. These issues were selected because housing bonds are excepted from the general Glass-Steagall prohibition against commercial bank underwriting and, unlike general obligation bonds, most often involve negotiated underwritings rather than underwritings through public bids.

It has been suggested that commercial banks have used their ability to provide necessary credit facilities as leverage to obtain managing underwriting positions. Although eligible to underwrite housing revenue bonds since 1968, banks have had modest success in becoming managing underwriters until of late.

The data shows a remarkable coincidence of banks supplying letters of credit for put bonds and for security and participation in the managing underwriting group. There were approximately half as many housing bond issues in 1981 as in 1980 (primarily as a result of new Congressional restrictions and market conditions). However, as Table I indicates, Citibank was able to participate as a managing underwriter in even more negotiated housing offerings in 1981 than in 1980. Crocker, which did not participate as a manager in any negotiated housing issues in 1980, was a managing underwriter in six in 1981. Manufacturers Hanover also did not participate as a manager in any negotiated housing bond underwritings in 1980 yet participated as a manager in two such offerings in 1981.

In every single negotiated housing bond offering involving a letter of credit supplied by Citibank, Crocker or Manufacturers Hanover, the bank was in the management group--24 times out of 24. It appears as if none of the banks was a manager in a housing bond issue in 1981 where it did not supply a credit facility.

These statistics are testimony to a dramatic entry into negotiated underwritings of housing bonds as a result of the financial capacity to provide credit facilities. In addition, in every one of the 24 situations the banks obtained the right to invest all proceeds of the bond issues and related funds for the life of the bond issues. Table II provides the details of the 24 transactions which have been identified.

Typically, the banks involved in these transactions receive the following as compensation:

1. Fees paid to managing underwriters and a manager's participation in the underwriting;
2. Annual fees (typically, 45 basis points at closing and 90 basis points per year);
3. The spread between rates paid under the investment contract and the bank's investment yields; and
4. A termination fee (payable from monies left at the conclusion of the program in an amount sufficient to increase each annual fee to 112 basis points).

The value of these various income sources is, of course, dependent on many factors. These include interest rates over the life of the program (which would impact on the value of the investment contract and availability of money to pay the termination fee) and the number of mortgage loan prepayments experienced by the issuer (which would affect the amount of outstanding bonds against which the annual fee percentage is applied).

For example, in a State of New York Mortgage Agency $100,000,000 bond issue ($96,650,000 of which were put bonds) the "break even" tax exempt rate (i.e., the market rate for one-year, tax-exempt debt at which the bank's loss on resale of bonds "put" back to it exceeds its profit from the transaction) was 18%. When the tax-exempt rate for one-year paper is less than 18% the bank makes money, when greater than 18%, the bank loses money. (At no point in history has one-year tax-exempt paper approached a rate anywhere near as high as 18%). In this transaction the before-tax value of the components of income other than the management fee, assuming a constant 13% tax-exempt rate and 100% FHA prepayment experience, was $23,840,000. Using the same tax-exempt rate, but assuming no prepayments, the payment to the bank would be in excess or $50,500,000. Actual prepayment value of the experience would probably fall between 100% of FHA experience (the assumption required by Section 103A of the Internal Revenue Code, as amended) and no prepayments. Therefore, the range for the fee, exclusive of the share of the underwriting management fee, was between $23,840,000 and $50,500.000.

TABLE I

1980-1981 Comparison of Commercial Bank Involvement in Housing Issues

		1980		1981
Total Housing Issues		484 ($14,267,101,944)		239 (7,065,452,00)
Total CITIBANK Negotiated bond underwritings in which it was a member of management group		14		16
Total credit facilities supplied in underwritings in which it was a member of management group		7		16
Put Bonds	3		15	
Security Letters of Credit	4		1	
Total CROCKER NATIONAL BANK				
Negotiated underwritings in which it was a member of management group		0		6
Total Credit facilities supplied in underwriting in which it was a member of management group		0		6
Put Bonds	0		5	
Security Letters of Credit	0		1	
Total MANUFACTURERS HANOVER TRUST CO. in which it was a member of management group		0		2
Total credit facilities supplied in underwritings in which it was a member of management group		0		2
Put Bonds	0		2	
Security Letters of Credit	0		0	

TABLE II

SCHEDULE OF PUT BOND DEALS

CITIBANK PUT BOND DEALS

	ISSUE	MEMBER OF MANAGEMENT GROUP	PUT BOND FEATURE	INVESTMENT AGREEMENT
1.	\$50,000,000 City of Baltimore, July 1, 1981	X^a	X^1	X^2
2.	\$23,205,000 Barton Co., Kansas, Arpil 1, 1981	X^a	X^1	X^2
3.	\$150,000,000 Brevard Co. Housing Finance Authority, February 1, 1981	X^c	X^1	X^2
4.	\$43,915,000 Denton Co. Housing Finance Corp., November 1, 1980	X^b	X^3	X^2
5.	\$18,845,000 Hutchinson, Kansas, April 1, 1981	X^b	X^1	X^2
6.	\$64,715,000 Johnson Co., Kansas, April 1, 1981	X^b	X^1	X^2
7.	\$200,000,000 Louisiana Public Facilities Authority, April 1, 1981	X^b	X^1	X^2
8.	\$104,750,000 State of New York Mortgage Agency, November 1, 1981	X^b	X^1 X^2	
9.	\$130,000,000 Orange Co., Fla. Finance Authority, May 1, 1981	X^a	X^1	X^2
10.	\$118,500,000 Pomona, CA. Redevelopment Agency, April 1, 1981	X^c	X^1	X^2
11.	\$105,000,000 Pueblo Co., Colo., March 1, 1981	X^b	X^4	X^2

	ISSUE	MEMBER OF MANAGEMENT GROUP	PUT BOND FEATURE	INVESTMENT AGREEMENT
12.	$24,800,000 Residential Housing Facilities Board of Pulaskie Co., Arkansas, December 1, 1980	X[b]	X[3]	X[2]
13.	$25,000,000 Shawnee Co., Kansas, June 1, 1981	X[b]	X[1]	X[2]
14.	$23,305,000 Tom Green Co. Housing Finance Corp., November 1, 1980	X[a]	X[4,5]	X[2]
15.	$24,595,000 Williamson Co., Tex. Housing Development Corp. December 1, 1980	X[b]	X[3]	X[3]
	CROCKER NATIONAL BANK PUT BOND DEALS			
16.	$100,000,000 Alaska Housing Finance Corp., December 1, 1981 $75,000,000 Option Bonds	X[b]	X[6]	X[2]
17.	$35,000,000 Leavenworth Co., Kansas, November 1, 1983	X[a]	X[1,7]	X[2]
18.	$47,410,000 Massachusetts Housing Finance Agency December 1, 1981 $40,000,000 Option Bonds	X[b]	X[8]	X[2]
19.	$20,185,000 City of Roswell, N.M., September 1, 1981	X[b]	X[9]	O[10]
20.	$60,000,000 Seward Co., Kansas, October 1, 1981	X[b]	X[1,11]	X[2]
	MANUFACTURERS HANOVER TRUST COMPANY PUT BOND DEALS			
21.	$50,000,000 Duval Co. Housing Finance Authority	X[a]	X[12]	O[12]
22.	$150,000,000 Louisiana Housing Finance Authority, ($100,000,000 option bonds) Dec. 1, 1981	X[a]	X[13]	O[10]

NOTES

a No previous issue of Bonds by this Issuer.

b Was not in management group in previous issues of the Issuer in which no credit facility was supplied.

c Was in management group in previous issues because Bank agreed to provide Investment Agreement.

1 Letter of Credit Fee of .45% of aggregate amount of Option Bonds outstanding (not redeemed and retired by Issuer), payable semiannually in advance over life of issue plus Termination Fee equal to the difference between LOC fee at .45% and amount which would have been paid if LOC fee had been .56% over the life of the issue compounded semiannually at approximately 10%.

2 Bank has the right to invest substantially all funds and moneys under the Indenture/Resolution.

3 Terms not discernable from available data.

4 Letter of Credit fee of .45% of aggregate amount of Option Bonds outstanding payable semiannually in advance over life of issue.

5 Amount of Termination fee not discernable from data available.

6 Initial LOC fee of .5% of Option Bonds outstanding and semi-annual LOC fees of .5% of Option Bonds outstanding over life of issue.

7 Initial LOC fee of .45%; additional LOC fee of .0675% of Option Bonds outstanding payable on date of issuance.

8 Initial fee of $133,000; LOC fee of .45% of Option Bonds outstanding payable semiannually in advance; Termination fee equal to difference between LOC at .45% and .575% over life of issue.

9 Initial LOC fee of .0834% of Option Bonds outstanding times the number of months between delivery date and first interest payment date; LOC fee of .5% of Option Bonds outstanding payable semiannually for the life of the issue.

10 Investment Agreement awarded to another financial institution prior to Bank's entrance into the deal.

11 Initial LOC fee of .45% of Option Bonds outstanding.

12 Initial LOC fee of $2,000,000 payable at closing plus a percentage of the Option Bonds tendered payable semiannually in arrears. Tender option available to holders only from June 1 to July 1, 1986.

13 Initial LOC fee of $500,000 payable at closing plus a percentage of the Option Bonds tendered payable semiannually in arrears. Tender option available to holders only from June 1 to July 1, 1984.

The **Chairman**. Thank you, Mr. Jenrette.

Mr. Silver.

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. **Silver**. Thank you, Mr. Chairman. I am David Silver, president of the Investment Company Institute, the national association of the mutual fund industry. The institute has approximately 1,000 mutual fund members with 23 million shareholder accounts.

FOUR POINTS PUT FORTH LAST JUNE REITERATED

When we were privileged to testify before you last June, Mr. Chairman, on the conditions in the financial services industry, we made four points:

One, any competitive imbalance caused by money market funds was corrected by the Garn-St Germain Act which authorized money market deposit accounts. In only 1 year these accounts attracted over $380 billion, while money market funds stand at $170 billion. Moreover, when money market funds are measured against the $2 trillion in total demand and savings deposits held by depository institutions, it is clear that money market funds by themselves provide no rationale whatever for abandoning the separation of the banking and securities industries.

Two, commercial banks have maintained their market share relative to other types of financial intermediaries since World War II. Commercial banks, exclusive of their trust assets, account for almost 38 percent of all financial assets.

Three, bank expansion into the securities industry is not per se justified by mergers and acquisitions involving securities firms. While such combinations as Prudential, Bache, Sears, and Dean Witter have created formidible competitors for existing securities firms, these developments as such have nothing to do with commercial banks nor do they present any threat to the banks' competitive position.

Four, it is quite true that technology has affected the delivery of all financial services. However, the main impact of the new computer-based technology has been to annihilate geography, rather than to eradicate the inherent distinctions between banking and the securities business. Thus, reform legislation driven by technological developments should center on the repeal of the territorial limitations of the McFadden Act and not the repeal of the historic national policies set forth in the Glass-Steagall Act.

For these reasons, we do not see any compelling justification for legislation which would abandon the separation of the banking and the securities industries, which except for a short period in the 1920's has prevailed as public policy ever since the enactment of the National Banking Act of 1863.

However, we have proceeded in good faith to comply with Chairman Garn's repeated requests to arrive at a legislative accommodation. In so doing, we have focused on two major concerns: The establishment of an effective regulatory framework and the preservation of fair and open competition in the financial services industry.

Our written testimony details the specific regulatory proposals we have made, proposals which I am compelled to report have thus far been ignored by most proponents of expanded bank powers. This is unfortunate since our proposals are not based on abstract theory but on an historical record of commercial banking and the mutual fund business.

Chairman Shad of the SEC, Chairman Volcker of the Fed, and last week the State Securities Administrators have all indicated that the type of protections that we call for would be desirable. I might note that Chairman Volcker specifically referred to our suggestions in his testimony last year.

To fashion remedies for the specific regulatory problems which would result from bank entry into the mutual fund business requires hard work, but we hope that the committee moves to remedy these defects in S. 2181. I think we all share the belief that protection of the public interest is not a matter to be left to industry consensus.

To assure free and open competition is a more difficult task. It first requires the will to overcome the resistance of entrenched interests who want to preserve their governmentally protected turf while giving up nothing to competitors. More importantly, free and open competition in banking requires the reconciliation of two competing policy goals, each of which have strong claims to legitimacy.

The first of these is to assure a safe and sound banking system responsive to the credit needs of business and individuals in all sections of our country. I think we all believe that the first goal in banking regulation should be a safe and sound banking system. But in dealing with competition with other businesses, we must then consider the second goal which may be in conflict with the first, and that is to permit fair competition between all sectors of the financial services industry so that the competitive race belongs to the swift and its outcome is not preordained by Government.

The present bill does not reconcile these competing policy considerations. Let me explain what I mean. Regulation today is highly protective of banks from federally insured deposits to the geographical limitations restricting entry into local markets. Each of these protections are bottomed on reasonable public policy considerations, but these policy considerations from a different era have never been measured against the anticompetitive effects that arise when banks bring their unique Government mandated advantages to bear on competitors in other lines of commerce. In other words, legal protections in the public interest can be converted into commercial advantages for private gain.

Take, for example, one existing bank securities activity, investment management. As one of the bank witnesses testified last month, certain bank trust department activities are quite similar to mutual funds, indeed similar enough, it was argued, to justify bank expansion into the mutual fund business. We agree with the assertion of similarity, but we draw a far different conclusion.

BANKS USE PREFERRED REGULATORY POSITION TO ENHANCE THEIR COMPETITIVE POSITION

Banks have already used their preferred regulatory position as commercial banks to enhance their competitive position as investment managers. A variety of surveys has long indicated that long-term investment performance provided by bank trust departments are inferior to those provided by mutual funds and indeed insurance companies. Yet bank trust departments dwarf the mutual fund industry in size. The numbers are impressive.

Exclusive of personal trusts, the traditional business of bank trust departments, at year end 1982, banks managed some $480 billion in assets against a mutual fund total of $77 billion, exclusive of money market funds. As to equity securities, banks control equities to the extent of $292 billion, 44 percent of all institutional holdings, while mutual funds at that same time held equities of $49 billion.

Much of the bank holding of securities arise from bank management of corporate retirement plans. It is well known throughout the pension industry that corporations have historically selected banks as managers of their retirement plans to enhance their relationship with the commercial side of the bank regardless of investment performance. Now it is proposed to extend bank powers to permit them to sponsor mutual funds where the potential for similar leverage exists. The domination of yet another form of the investment business which is sure to follow will place the banking industry in effective control of even the largest American companies. Not only is such control a tendency not to be encouraged in a competitive economy, but it will increase the likelihood that commercial loan decisions of banks will be influenced by their investment management portfolio activities and vice versa.

As indicated in our written testimony, bank entry into the mutual fund business would greatly enhance the equity holdings of the banking sector. Initially equity holdings would expand sharply as large banking institutions in which the ownership of securities is concentrated acquire large mutual fund organizations. These additions would dramatically balloon bank concentration in holding of stocks in individual companies and industries.

The tendency toward concentration inherent in S. 2181 is not restricted to the holdings of equities by banks. The failure of the bill to assure competitive equity also creates powerful pressures for concentration in the provision of financial services because under the bill the winds of change blow only in one direction. As a result of the special privileges conferred on banks by Government, the financial services industry in this country will be centered around a few giant banking organizations. The tendency toward concentration of financial providers will not be subject to any significant countervailing pressures. The bill would not allow the Nation's largest securities firms to enter the banking business since these firms engage in the underwriting of corporate securities.

But even if securities firms abandon underwriting in order to engage in banking, the geographical protection within the banking laws would sharply limit their competitive force. The largest companies in the insurance and securities industries are national in scope. They distribute their financial products nationwide. The competitive strengths of a Prudential or a Merrill Lynch cannot be brought to bear in the banking industry while geographical restrictions remain in effect.

Now the witness for the American Bankers Association last month from Fergus Falls, Minn. eagerly endorsed the provisions of S. 2181 granting banks expanded powers. With all due respect, we would suggest that his enthusiasm for this bill would be tempered if the bill provided that the local mutual fund sales office and the local insurance agency could offer full banking services right in Fergus Falls while he offered their products.

In short, what S. 2181 does is to unwittingly act as a tremendous engine for the concentration of equity holdings and all financial services in banks. If this is to be prevented, the horizons of S. 2181 must be significantly broadened. This is a public policy issue because the bill, by not going down a competitive route, creates a one-sided situation. It cannot be only a bank deregulatory bill, but it must also be a securities and insurance deregulatory bill. It cannot expand bank powers into new areas while continuing to protect banks from competition. It must permit all of the components of the financial services industry to bring their unique strengths to bear on each other in a competitive arena stripped of the protectionism banks currently enjoy.

Thank you, Mr. Chairman.

[Complete statement follows:]

WRITTEN STATEMENT OF THE INVESTMENT COMPANY INSTITUTE BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS ON S. 2181, THE "FINANCIAL SERVICES COMPETITIVE EQUITY ACT" AND S. 2134, "DEPOSITORY INSTITUTIONS HOLDING COMPANY ACT AMENDMENTS OF 1983"

March 7, 1984

I am David Silver, President of the Investment Company Institute, the national association of the mutual fund industry. The Institute has approximately 1,000 mutual fund members with 23 million shareholder accounts. The mutual fund industry is a vigorous and highly competitive business. We strongly believe that our success has been enhanced by an effective system of securities regulation. We are therefore vitally concerned with any legislation which would dilute sound regulation or hinder free and open competition. We welcome the opportunity to testify on S. 2181 and S. 2134, both of which would significantly impact on both regulation and competition. Our major concern is with Title I of S. 2181 and Section 5 of S. 2134, both of which would repeat the experiment which occurred earlier this century when banks and their affiliates were permitted to sponsor and distribute investment trusts (mutual funds).[1]

INTRODUCTION: THE GLASS-STEAGALL ACT AS A REFLECTION OF NATIONAL BANKING POLICY

An historical perspective of national banking law is helpful because it throws into sharp relief two issues which the current debate on expanded bank powers has thus far tended to overlook.

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[1] The following remarks concerning S. 2181 are apposite to S. 2134.

First, the Glass-Steagall Act, enacted 50 years ago, was not an aberration or an hysterical reaction by an uninformed Congress against bank excesses of the 1920s. It represented a serious and deliberate decision to return to historic national principles of separating banking and commerce and more particularly banking and the securities business. Thus, any break with the past ought to proceed from a solid finding that these long-standing principles are wrong or that the environment has so changed that they are no longer applicable. The second issue is whether environmental changes have eliminated the fears and concerns underlying the separation of banking and commerce and, if not, whether adequate substitute controls have been fashioned or proposed.

It is important to emphasize the preceding points: the Glass-Steagall Act, enacted in 1933, and the geographical restrictions of the McFadden Act, enacted in 1927, did not represent radical departures in American attitudes towards banks and their proper role in our economy. There had been a national consensus since Andrew Jackson's epic struggle with the Second Bank of the United States that banks should be essentially regional institutions and that they should be confined to the business of banking. The concerns were economic and political. First, it was perceived that the concentration of economic power in banks would be undesirable and that such concentration would also lead to undue political power. Second, there was the feeling that banks should not engage in commerce because they would be compromising their role as impartial allocators of credit and would be competing unfairly with their own customers.

The National Banking Act of 1863, re-enacted in 1864, its legislative history and its interpretations by the courts during the remainder of the 19th century fully reflect the historical concerns. The Congressional debates preceding the enactment of the National Banking Act recounted how the Second Bank of the United States could have achieved political goals by wielding its economic muscle. That Bank, it was asserted in Congressional debate, could cause "great inconvenience and sometimes terrible disaster...to the trade and commerce of different localities by arbitrarily interfering with the management of the branches by reducing suddenly their loans... ."[2] Reflecting the same concerns, the first Comptroller of the Currency, whose office was created by the National Banking Act, stated explicitly that one purpose of that law was to prevent the creation of a "mammoth corporation" which "could control the business and politics of the country."[3]

During the remainder of the 19th century, the courts consistently interpreted the National Banking Act to confine banks to the business of banking despite various legal machinations employed by banks to break down the walls. However, by the beginning of the 20th century, under repeated assault, the walls did start to crumble as national banks found legal devices to enter the securities business. One such device was the creation of state-chartered securities affiliates. A major attempt to stem the erosion of the historic policies occurred in 1911 in an opinion by Solicitor General Lehmann, concurred in by Attorney General Wickersham, which declared that the creation of bank holding companies which could invest and control businesses outside of banking were illegal under the National Banking Act.

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[2] Congressional Globe, 37th Cong, 2nd Sess., Pt. I, p. 616.

[3] Banker's Magazine, 1863, Vol. XVIII, pages 8 and 9.

The 1911 opinion is an important statement which sums up the historic position on the proper role of banks in our society.

Specifically, on the merging of banking and commerce the opinion was very clear. After stating that a bank holding company could invest in any kind of business, the opinion concluded:[4]

> "The other enterprises in which the company is engaged may stand in need of credit and of funds, and it is too much to expect that the company's banks will deal simply as banks, equitably and impartially as between its own subsidiaries and persons and corporations with whom it is not affiliated. The temptation to the speculative use of the funds of the banks at opportune times will prove to be irresistible. Examples are recent and significant of the peril to a bank incident to the dual and diverse interests of its officers and directors. If many enterprises and many banks are brought and bound together in the nexus of a great holding corporation, the failure of one may involve all in a common disaster. And if the plan should prosper it would mean a union of power in the same hands over industry, commerce, and finance, with a resulting power over public affairs, which was the gravamen of objection to the United States Bank."

The opinion of the Solicitor General was not heeded, and banks, with the acquiescence and connivance of the bank regulators, flooded into the securities business, including the mutual fund (investment trust) business during the 1920s. After

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[4] Congressional Record, May 10, 1932 at page S 9904.

Congress legitimized these activities in 1927, grave abuses occurred and six years later Congress repaired the hole in the dike by once again barring banks from virtually all securities activities.

For all of the reasons cited in our testimony today, the Institute does not see any compelling justification to abandon lightly the separation of the banking and the securities industries. The consequences of such a departure from public policy -- a policy which has generally prevailed since the enactment of the National Banking Act of 1863 -- are revolutionary and ought only to follow the most careful study of the probable effect -- a study which we point out has never been performed.

REPEATING THE BANK INVESTMENT TRUST EXPERIMENT

Proponents of bank entry into the mutual fund business argue that the abuses of the 1920s were restricted to bank underwriting of corporate stocks and bonds and that the abuses did not involve bank operation of mutual funds. Therefore some proponents of what is now euphemistically being referred to as a "consensus" or "core" bill urge that the banking industry be given mutual fund authority without further study. They argue that it would be wholly prudent to permit banks to sponsor mutual funds and distribute their shares to the public, while continuing the Glass-Steagall bar on other forms of securities underwriting by banks. History contradicts all these claims. The only justification for granting banks authority to enter the mutual fund business, while denying them other broad authority they seek, would not lie in logic but in political expediency.

First, banks were heavily involved in the mutual fund business in the 1920s,[5] and there were widespread abuses in the operation of the bank-sponsored funds (then known as "investment trusts"). Second, these abuses took place regardless of whether the fund was sponsored by the bank or by a separate affiliate. Indeed, the pool of "other people's money", which is the essence of a mutual fund, is more susceptible to managerial conflicts than merely distributing the securities of a third party to the public as an underwriter.

Many of the widespread abuses stemmed from the bank's role as a commercial lender. The abuses included fund investment in debentures of a troubled company which was financed by the bank;[6] fund purchases of illiquid loans from the bank;[7] and fund loans to accommodate "good customers" of the bank.[8] In addition, there were instances in which the fund had invested in companies in order to further the bank's commercial interests -- for example, fund purchases of stock in other banks in anticipation of statewide branching;[9] and so that the affiliated bank would be in a better position to sell correspondent services to these smaller banks.[10] Other abuses included fund investment in stock of the bank;[11] fund loans to the bank,[12] its securities affiliate,[13] bank officers and directors,[14] and companies controlled by insiders;[15] fund purchases of securities from the bank or its securities affiliate;[16] fund investment in companies in which insiders had an interest;[17] and fund purchases of securities being underwritten by the bank's securities affiliate.[18]

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[5] "The new era banker felt he must rescue the people by encouraging them to come to the bank for investment advice. The small investor was told that he should share the opportunity to grow rich with America, by putting his money in investment trusts. In order to facilitate this new service many large banks organized investment trusts of their own...." James Gerald Smith, Facing the Facts, 157 (1932).

[6] Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission Pursuant to Section 30 of the Public Utility Holding Company Act of 1935 (1939-1940), Pt. 3 at 127 (hereinafter cited as "Investment Trusts Study").

[7] Ibid at 150-51.

[8] Ibid at 2658 n. 44.

A 1931 Report of a Subcommittee of the Senate Banking Committee stated the following concerning investment trusts (mutual funds) sponsored by banks:

> "Activities of a bank's security affiliate as a holding or finance company or an investment trust are also fraught with the danger of large losses during a deflation period. Bank affiliates of this kind show a much greater tendency to operate with borrowed funds than do organizations of this type which are independent

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[9] Ibid at 167. Also see Pt. 4 at 159-160.

[10] Ibid at 167.

[11] Ibid at 131 and 162.

[12] Ibid at 149.

[13] Ibid at 130, 149 and 157.

[14] Ibid at 2655 and 2660-61.

[15] Ibid at 132-33 and 2716.

[16] Ibid at 130, 149 and 150.

[17] Ibid at 133 and 2716.

[18] Ibid at 134.

> of banks, the reason being that the identity of control and management which prevails between the bank and its affiliate tends to encourage reliance upon the lending facilities of the former.
>
> In fact the mere existence of an affiliate which might be made the receptacle for unwise loans and investments when needed tends to reduce the degree of caution exercised by bank managements, there is reason to believe."[19]

Indeed, following the debacle of the 1920s, bankers themselves testified that the problems associated with bank and bank affiliate sponsorship of investment companies were so great that these activities should be totally prohibited in the future.[20]

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[19] Operation of the National and Federal Reserve Banking Systems, Hearings Before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong., 3d Sess., Pt. VII, at 1059-60 (1931).

Thus it is clear that the bank abuses of the 1920s involved bank operation of mutual funds and that these abuses took place regardless of whether the fund was sponsored by the bank or by a separate affiliate of the bank.

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[20] See, e.g., Investment Trusts Study, testimony of the Chairman of Chatham Phenix National Bank and Trust Company of New York, at 136:

> "My experience was that if I was doing it today, I wouldn't do it at all, and I would never have formed the corporation, but this is hindsight, that is an after point of view....I think that the whole theory of affiliated investment companies with banks was a mistake, especially when it was a distributing corporation." (emphasis added)

and testimony of the President of Central Trust Company of Illinois, Ibid at 179:

> "[Concerning] my philosophy of what a commercial bank should confine itself to in the way of financial service....As far as the relationship with an investment trust is concerned, particularly where that trust...has outside shareholders, even though the formation of the company made it very apparent that its operations were to be administered by the same officers that administered the [bank and its securities affiliate], nevertheless any conscientious officer will try to administer each of those three companies for its own best interest. As long as your security market is stable or inclining upward, as long as you are in a period of reasonable prosperity, I feel that that sort of relationship is endurable. But, once the reverse takes place, then your officers are in constant embarrassment."

Also see the conclusion of the Counsel to the SEC Study on Investment Trusts and Investment Companies:

> "I think there is nothing so clear as the fact that this relationship between the banks and the investment companies has proved unfortunate. The president of the Liberty Bank said that there ought to be absolute segregation. The head of the M. & T. Bank said the same thing. The head of the Central Illinois said that the relationship was unsatisfactory. I do not think there is any question about it as far as our record is concerned." Hearings on S. 3580 before a Subcommittee of the Senate Committee on Banking and Currency, 73d Cong., 3d Sess. 885 (1940).

LEGISLATIVE RECOMMENDATIONS: S. 1609 AND S. 2181

When we testified before this Committee last year we stated that we did not see any public interest in legislation which would erode or abandon the separation of the banking and the securities industries which, except for a short period in the 1920s, has prevailed as public policy since the the National Banking Act of 1863.

However, we have proceeded in good faith to comply with Chairman Garn's and the Treasury's repeated requests to arrive at a legislative accommodation. In so doing, we have focused on two major concerns: the establishment of an effective regulatory framework, and the preservation of fair and open competition in the financial services industry.

As discussed above, the provisions of S. 2181, which require that bank mutual fund activities take place in a separate affiliate, provide no particular protection against wrongdoing. Moreover, it is clear that application of the existing securities laws will not provide an adequate regulatory framework. The existing securities laws, notably the Investment Company Act of 1940, were enacted by Congress to deal with specific conflicts which arise when investment banking firms, brokerage firms and investment advisers sponsor, manage and distribute the shares of mutual funds. However, the Act does not purport to deal with the unique conflicts of interest which result when commercial banks or their affiliates engage in the mutual fund business. At the time when the Investment Company Act was enacted, Congress believed that the Glass-Steagall Act entirely prohibited banking institutions from engaging in the mutual fund business. As SEC Chairman Shad has testified:

> "The Investment Company Act was adopted after the Glass-Steagall Act separated commercial banking from investment banking. Thus, the Investment Company Act could not address the problem of bank conflicts of interest specifically."[21]

Therefore, as other witnesses before this Committee, including the North American Securities Administration Association, have indicated, if commercial banks or their affiliates are permitted to organize, sponsor and distribute the shares of mutual funds, it will be necessary to revise the Investment Company Act to deal with the unique conflicts of interest which are likely to result.[22]

Following our testimony before the Committee last June, we met with Deputy Secretary of the Treasury McNamar and his staff to discuss the defects in the Treasury's proposed legislation (S. 1609). On August 26, 1983, at Mr. McNamar's invitation, we submitted to him a detailed memorandum identifying major deficiencies in the Treasury bill and a series of specific amendments designed to remedy them.

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[21] Hearings on S. 1686, S. 1703, S. 1720 and S. 1721, before the Senate Committee on Banking, Housing and Urban Affairs, 97th Cong., 1st Sess., Pt. II at 914 (1981).

[22] See, e.g., Written Statement, NASAA, February 29, 1984, at pages 6-7.

Attached as an appendix to this testimony are the details of the specific proposals we made -- proposals, which I am compelled to report, have thus far been ignored by most government proponents of expanded bank powers and rejected by the banking industry. This is unfortunate since our proposals are not based on abstract theory but on an historical record of grave abuse summarized earlier in this statement -- abuses which must not be repeated. Legislation devoid of provisions to control the inherent conflicts of interest between commercial banking and mutual fund activities is simply a recipe for the repetition of the financial disaster which marked the culmination of previous experiments permitting banks to mass-merchandise securities. I might note that it was to our proposals in these problem areas that Chairman Volcker referred when he testified last fall that the suggestions advanced by the Institute should receive careful consideration.[23] To date, they have not.

Because S. 2181 is nearly identical to S. 1609 with respect to mutual fund activities, the Institute's submission to the Treasury is equally applicable to S. 2181. We would make three general comments about both bills:

1. Although both bills ostensibly embody the concept of "regulation by function," they fail to implement this concept by permitting banks to continue to engage in numerous securities activities completely free from regulation under the federal securities laws. As bank securities activities have expanded,

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[23] Transcript of September 13, 1983 at pages 35 and 36.

this situation has become increasingly anomalous.[24] It makes no sense if legislation expanding bank securities powers does not rationalize the regulatory structure and subject all bank securities activities to securities law jurisdiction.

2. Although the bills greatly expand the scope of permissible bank securities activities, they fail to address adequately the conflicts of interest, financial hazards and other abuses that are likely to result from these new activities. As noted above, the present securities laws are not adequate to deal with these problems because they were enacted based on Congress' belief that banks had been effectively excluded from the securities business.

3. Although the bills purport to broaden the scope of permissible bank activities in order to enhance competition, the bills in fact would create a playing field tilted sharply and unfairly in favor of large banks, at the expense of the members of the securities industry in general, and of the mutual fund industry in particular.

For these reasons, S. 2181 represents no improvement over S. 1609, except to the extent that S. 2181 attempts to address concerns about concentration, about which we will comment later.

To fashion remedies for the specific regulatory problems summarized in the first two points above merely requires hard work and good faith, and we hope that the Committee moves to remedy these defects in S. 2181 to protect the public interest.

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[24] As pointed out on pages 15-16, banks trust department, exclusive of their historic management of personal trusts, now manage over $480 billion.

However, to address the third point and to assure free and open competition is a much more difficult task.

UNFAIR COMPETITION

The effort to assure free and open competition requires the will to overcome the resistance of entrenched interests who want to preserve their governmentally protected turf while giving up nothing to competitors. More importantly, free and open competition in banking requires the reconciliation of two competing policy goals, each of which has strong claims to legitimacy. The first of these is to assure a safe and sound banking system, responsive to the credit needs of business and individuals in all sections of our country. The second goal is to permit fair competition between all sectors of the financial services industry, so that the competitive race belongs to the swift, and its outcome is not preordained by government. It is clear that the present bill does not come to grips with the issue of these competing policy goals, much less their reconciliation.

Let me explain what I mean. Regulation today is highly protective of banks. Banks enjoy the advantages of federally insured deposits and access to the Fed discount window and the Federal funds market. Geographical limitations restrict entry into local markets to the advantage of local banks. Each of these advantages are based on reasonable public policy considerations. But these policy considerations, from a different era, have never been measured against the anti-competitive effects that arise whenever banks bring their unique advantages to bear on competitors in other lines of commerce -- as is now being proposed.

COMPETITIVE ADVANTAGES AND BANK DOMINATION OF INVESTMENT MANAGEMENT

Take, for example, one securities activity in which banks presently engage -- investment management. As one of the bank witnesses testified before this Committee last month, certain bank trust department activities are quite similar to mutual funds -- indeed similar enough, it was argued, to justify bank expansion into the mutual fund business.[25] We would agree with the assertion of similarity, but we draw far different conclusions.

Banks have already used their preferred regulatory position as commercial banks to enhance their competitive position as investment managers. While our surveys and those conducted by others have long indicated that investment management results provided by bank trust departments are inferior to mutual fund performance, bank trust departments dwarf the mutual fund industry in size.

The numbers are impressive. Exclusive of personal trusts -- the traditional business of bank trust departments -- at year-end 1982 banks managed some $480 billion in assets against the mutual fund total of $77 billion (exclusive of money market funds). As to equity securities, banks controlled equities to the extent of $292 billion, while mutual funds at the same time held equities worth $49 billion. Indeed such is the disparity in size between the two industries and such is the degree of concentration in the banking industry that the top five banks held approximately $54 billion in equities, an amount similar to that held by the entire mutual fund industry.

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[25] Written Statement, American Bankers Association, February 22, 1984, at page 16.

Much of the bank holdings of securities arise from bank management of corporate retirement plans. It is well-known throughout the pension industry that corporations historically have selected banks as managers of their retirement plans to enhance the corporation's relationship with the commercial side of the bank, despite inferior investment performance.[26]

Thus, banks clearly use the leverage they gain from being commercial banks to enhance their standing in a very different business -- investment management. Whether one labels such enhancement as tie-ins or "bundling," the new euphemism the bankers came up with in their testimony last month, it is equally unfair competition.

COMPETITIVE ADVANTAGES AND CONFLICTS OF INTEREST

The existing competitive advantages enjoyed by commercial banks not only have resulted in bank domination of investment management; they also have produced major conflicts of interest.

The last major Congressional study that dealt with this issue was a staff study prepared for the Subcommittee on Domestic Finance, House Committee on Banking and Currency, 1968. As may be seen in the following paragraphs, Professor Edward S. Herman drew heavily on this study in his subsequent analysis of conflicts of interest in banking:[27]

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[26] See, e.g., Editorial, "Investing Solely in Interest of Beneficiaries," Pensions & Investments, January 1, 1979, at 6.

> "That banks might use trust department assets as a means of acquiring influence or even control over customers or potential customers was suggested with considerable force in the Patman Report of 1968, which showed that not only did trust banks manage a huge volume of assets (about $250 billion at the time), but also that many individual banks held significant stock positions in a number of portfolio companies. The report found that the forty-nine leading trust banks had as many as 5,270 separate holdings of 5 percent or more of the stock of portfolio companies, often with director interlock supplementing the stock ownership."

Professor Herman points out that banks do not exercise effective control over all stocks which are in their portfolios. Nevertheless, he concludes that:

> "Even with the major qualifications in the data just discussed, the great trust banks have large stock positions in many listed companies and may have used, or in the future may choose to use their enormous assets to acquire influence or control. Or they may have had influence and/or control thrust upon them by the sheer magnitude of their investment activities.
>
> "In quite a few industries, a number of bank trust departments held multiple and overlapping large equity holdings along with substantial creditor positions, often supplemented by interlocks. These holdings raise questions of possible collective banker domination over major companies and even major industries, resulting from common interests and viewpoints, with or without coordination."

More recently, Professor Lance Girton reviewed the evidence on the concentration of shares of American corporations in the portfolios of institutional investors. In addition, he examined various aspects of the relationship between institutional investors and portfolio companies and concluded:[28]

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[27] Edward S. Herman, Conflicts of Interest: Commercial Bank Trust Departments, The Twentieth Century Fund, (New York, 1974), pp.30, 31, 35.

> "Banks have been distinguished from other financial institutions by the size of their equity holdings and the multiplicity of the relationships between banks and corporate customers. Evidence has been presented that indicates that the large banks are interconnected to a degree that raises doubt about whether decision making is independent. Also, in some industries a single bank holds substantial positions in several competing corporations within an industry."

On the important issue of whether banks exercise control over portfolio companies, Professor Girton took a somewhat different position than scholars in earlier studies. He emphasized industry-wide competitive effects rather than the effect of control of individual firms:

> "The major problem is not bank control of individual corporations, though that may exist and be important, but rather the influence of large banks over several competitive companies in an industry. The data presented here suggests that the financial system, centered in a few large banks, may work to reduce competition and independent decision making across several industries in the United States.
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> * * *
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> "We suggest that the impacts on competition may reach into many markets where interlocked financial institutions,

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[28] Lance Girton, Professor of Economics, University of Utah. This paper is an extension of earlier work done with Donald Farrar and published jointly under the title "Institutional Investors and Concentration of Financial Power: Berle and Means Revisited," The Journal of Finance, May 1981. Research support was provided by the Investment Company Institute and the Roland Stucki Fund for Research in Finance, University of Utah.

> especially interconnected banks, have substantial relations with several companies in an industry. The implications of financial concentration for how the economy will function are important and far reaching. The questions that existing financial concentration raise should be carefully considered in the legislative process determining the proper set of institutional restrictions on the banking system."

The studies cited above tend to focus on relationships between banks and portfolio companies. While this is an exceedingly important subject, it by no means exhausts the possibility for conflicts. Therefore, it may be useful to review a summary of the various conflicts of interest that may exist within banks and bank holding companies, as they were described in a 1975 study that attempted to assess the public interest aspect of banking.[29]

> "Conflicts of interest of numerous types may exist within a commercial bank:
>
> o commercial bank investments in municipal securities may result in conflicts of interest when decisions are made concerning trust department portfolio composition and bank lending decisions relating to those governments and their contracts;
>
> o similar conflicts may arise in the underwriting of such securities;,
>
> o commercial loan decisions may be influenced by the trust department's portfolio composition and *vice versa*;
>
> o uninvested trust department cash poses a conflict since it may be a source of interest-free funds to the bank.

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[29] Stanley W. Black III, Glenn Canner, and Robert G. King, The Banking System: A Preface To Public Interest Analysis, (February 1975), pp.6, 7.

> "The number of potential areas of conflicts of interest and anti-competitive arrangements in banking increase substantially when nonbank subsidiaries are added through holding companies. Within holding companies, conflicts may arise involving:
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> o loans to affiliates;
>
> o bank underwriting of affiliates' commercial paper;
>
> o bank sales and purchases of services from affiliated companies;
>
> o bank efforts to support a failing affiliate at the expense of the bank's stockholders and depositors; and/or
>
> o trust department holdings of stock or debt in affiliates."

BANK ENTRY INTO MUTUAL FUNDS: AN INVITATION TO INCREASED CONCENTRATION OF EQUITY OWNERSHIP

As mentioned earlier, bank trust departments held about $292 billion of equities at the end of 1982, or about 44 percent of all institutional holdings of stock. The top 20 bank trust departments, moreover, account for 50 percent of all bank equity holdings. Viewing concentration from a somewhat different perspective, it is also evident that this small number of bank trust departments already hold a significant portion of the total outstanding shares of key companies and industries, many of which are also borrowers or potential borrowers from the commercial banking side of these banks.

Now it is proposed to extend bank powers to permit them to sponsor and mass-merchandise mutual funds, where the potential for increased tie-ins and "bundling" exists. Aside from the fact that this extension will have a devastating effect on the mutual fund industry -- both on those who manage mutual funds and those who sell them -- there are other public policy implications. The domination of yet another form of the investment business will place the banking industry in effective control of even the largest companies in America.

Bank entry into the mutual fund business would greatly increase the equity holdings of the banking sector. Over the long run, concentration would increase because banks would steadily build equity portfolios in tandem with their control over the investment policies of stock mutual funds. Initially, however, these equity holdings would expand sharply as large banking institutions move quickly to acquire large mutual fund advisory organizations. There is a precedent for this belief. When banks were given permission to offer brokerage services, the second largest bank holding company -- Bank of America -- acquired the largest discount brokerage firm, Charles Schwab. This would also occur in the mutual fund area as large banks sought to achieve instant pre-eminence by acquiring large existing insurance companies and mutual fund advisory organizations.

For example, if the top 20 bank holders of equities were to acquire the top 20 mutual fund advisory organizations, they would add, over time, about $100 billion to their equity holdings (at portfolio values that prevailed in mid-1983). These additions would dramatically balloon bank concentration in holdings of the stock issues of individual companies and industries.

The table on page 23 demonstrates what would happen to common stock concentration ratios (by actual count) if these acquisitions should occur. For comparison, the table also demonstrates the change in common stock concentration ratios if the 20 largest bank holders of equities were to acquire, in addition, the top 20 insurance company equity holders. In both instances, bank equity holdings increase, but it is clearly the acquisition of the mutual fund advisory firms that would be the primary cause of the sharp increases in concentration ratios.

The expansion of the banking sector's holdings through acquisitions of mutual fund advisory organizations, moreover, is only the down-payment. Bank equity holdings would continue to grow over the longer term -- along with concentration and potential conflicts -- as investors channeled dollars into newly created bank equity mutual funds.

BANK CONCENTRATION—BEFORE AND AFTER VALUE OF BANK HOLDINGS OF EQUITIES AS A PERCENT OF TOTAL AMOUNT OUTSTANDING:

		AFTER 20 BANK ACQUISITIONS OF:	
COMPANY	TOP 20 BANK TRUST DEPARTMENTS	TOP 20 MUTUAL FUND ADVISORY ORGANIZATIONS	TOP 20 MUTUAL FUND ADVISORY AND INSURANCE COMPANIES
IBM	12.3%	18.5%	21.1%
AT&T	4.7	8.3	9.2
GENERAL ELECTRIC	10.6	15.8	17.9
STANDARD OIL, CALIF.	19.0	21.4	23.1
EXXON	7.8	9.3	10.3
GENERAL MOTORS	7.9	11.4	13.2
SCHLUMBERGER LTD.	8.3	13.3	15.1
INDUSTRY			
AUTO PARTS	15.8%	22.3%	24.8%
HOTEL—MOTEL	14.2	20.7	22.1
TRUCKERS	12.9	25.2	28.8
PUBLISHING	12.4	23.8	26.3
AIR FREIGHT	10.3	22.3	28.5

THE ANTI-CONCENTRATION PROVISION IN S. 2181

Recognition of the dangers of concentration inherent in the Treasury's legislative proposal (S. 1609) to amend the Glass-Steagall Act prompted Senate Banking Committee Chairman Garn to propose limits on the ability of the largest banks to acquire other financial institutions. These limits, as proposed in S. 2181, would generally apply to the 25 largest bank holding companies and are designed to restrict the amount of consolidated capital which could be used for acquisitions to 25 percent.[30]

Since S. 2181 does not specify the capital concept that should be used in calculating the amount that banks could theoretically spend for acquisitions, the Institute used the total capital figure. However, even if equity capital -- the smallest number -- is the capital concept which would be ultimately chosen, Citicorp and Bank of America combined, could acquire mutual fund assets equal to almost two-thirds of the entire fund industry. If total capital is used as the basis for the calculation of "spendable" dollars, Citicorp alone, could buy 80 percent of the entire fund industry.

This is due to a combination of two factors. First, the large bank holding companies are so big that, even under the proposed limitation, they still have huge sums to use for acquisitions. Second, the entities to be purchased in the mutual fund business are the management companies, which are very small compared to the mutual funds they operate.

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[30] The term, consolidated capital, is not defined in S. 2181. Several different concepts may be used. The Federal Reserve, for example, compiles data for: equity capital, primary capital, and total capital. Equity capital includes common stock issued by the company. Primary capital includes common stock plus perpetual preferred stock, loan loss reserves, and other minor items. Total capital includes primary capital and long-term subordinated debt.

THE LIKELY RESULT OF S. 2181 - CONCENTRATION OF FINANCIAL SERVICES AND ECONOMIC POWER IN BANKS

The existing concentration of investment management and equity holdings in a few banks might in itself give pause to yet further expansion of bank authority in this area. However, the failure of S. 2181 to assure competitive equity makes it certain that the winds of change will blow in one direction. As a result of the special privileges conferred on banks by government, the financial services industry in this country will be centered around a few giant banking organizations. Under S. 2181, all large banks need do, after the observance of a few legal niceties, is to hang out a shingle announcing that they are in the mutual fund business, the insurance business and the banking business, and increased concentration of both equity holdings and financial services will inevitably follow.

The tendency towards concentration inherent in the provisions of S. 2181 will not be subject to any significant countervailing competitive pressures. The bill would not allow the nation's largest securities firms to enter the banking business since these firms engage in the underwriting of corporate securities. But even if those firms abandoned underwriting in order to engage in banking, the geographical protectionism in the banking laws would sharply limit their competitive force. The largest companies in the securities and insurance industries are national in scope. They distribute their financial products nationwide and cannot accommodate their distribution channels to the geographical restrictions imposed on banking. The competitive strengths of a Prudential or a Merrill Lynch cannot be brought to bear in the banking industry while these restrictions remain in effect. The witness for the American Bankers Association last month from Fergus Falls, Minnesota eagerly endorsed the provisions of S. 2181 granting banks expanded powers.[31] With all due respect, we would suggest that his enthusiasm to this bill would be tempered if it provided for fair competition whereby the local mutual fund sales office and the local insurance agency could offer banking services right in Fergus Falls while he offered mutual fund and insurance products.

In short, what S. 2181 does is to act unwittingly as a tremendous engine for the concentration of financial services and equity holdings in banks. Its fundamental failure is to narrowly focus on the issue of bank powers without any examination of the effect on competitors of the banking industry. Such an examination would reveal that, as the banking industry is now structured and protected, it is inevitable that the end result of the process set in motion by S. 2181 will be a concentration of financial power to a degree that the nation has never seen. If this is to be prevented, the horizons of S. 2181 must be significantly broadened. It cannot act one-sidedly as a bank deregulatory bill, but must likewise be a securities and insurance deregulatory bill. It cannot expand bank powers into new areas, while continuing to protect banks from competition, but must permit all of the components of the financial services industry to bring their strengths to bear in a competitive arena stripped of the protectionism banks currently enjoy.

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[31] Written Statement, American Bankers Association, February 28, 1984.

Investment Company Institute
1775 K STREET N W WASHINGTON D C 20006
202 293 7700

August 26, 1983

DAVID SILVER
PRESIDENT

Honorable R. T. McNamar
The Deputy Secretary of the Treasury
Department of the Treasury
Washington, DC 20220

Dear Mr. McNamar:

On July 19, 1983 we met with you, members of your staff and representatives of other agencies to discuss the mutual fund industry's preliminary views with respect to the Treasury Department's proposed Financial Institutions Deregulation Act of 1983. At the meeting we reaffirmed our desire to work with the Department and the Congress in fashioning appropriate legislation dealing with the financial services industry. However, we emphasized our strong belief that any such legislation must provide adequate public protection, insure reasonable competitive equality among all segments of the financial services industry, and guard against excessive concentration of economic power. We stated that our preliminary analysis of the bill indicated that it failed to achieve these essential objectives.

Any legislation which would repeal or drastically modify the Glass-Steagall Act is a serious undertaking. Assuming that there is a consensus that a major shift in public policy is now desirable, any implementing legislation must be thoughtfully constructed to avoid, so far as possible, the mistakes of the 1920s which caused such enormous damage to the economic and social fabric of our country. The crucible of history demonstrates that market discipline has not provided a sufficient regulatory mechanism for the intense conflicts of interest inherent in the combination of the banking and securities industries. Palliatives such as separate affiliates and the application of the existing securities laws cannot be expected to provide adequate investor protection. During the 1920s, many banks conducted their securities operations in affiliates and this did not save the country from disaster. The current securities laws cannot cope with these special problems since those laws were written in the conscious belief that banks were generally excluded from the securities business.

Since our meeting we and our members have had some opportunity to analyze the bill in greater detail. We regret to state that this analysis has reinforced our preliminary views regarding the bill and that we must now register our strong opposition to its enactment.

The bill as now written would not deregulate the financial services industry, but would simply authorize a number of the nation's largest banking institutions to enter new areas of endeavor, while retaining all of their special advantages over non-bank competitors. Enactment of the bill would rapidly destroy the securities industry as an independent line of business and would increase the concentration of economic power in a few giant banks.

An even greater flaw is that the bill would permit banks to enter the mutual fund business without attempting to guard against the precise conflicts of interest which history demonstrates are inherent in the combination of commercial banking and securities activities. Moreover, the bill fails to carry out the Treasury Department's stated goal of requiring all existing bank securities activities to be transferred to separate affiliates and thus made subject to regulation under the federal securities laws. This bill also does nothing to settle the many issues currently in litigation regarding the proper scope of bank securities activities.

We are particularly disturbed at many of the deficiencies in the bill since expert witnesses at recent Congressional hearings, including SEC Chairman Shad and Federal Reserve Board Chairman Volcker, identified specific problem areas and urged that they be dealt with in any legislation. Further, at recent hearings before the Senate Banking Committee and its Securities Subcommittee, the Institute offered a number of statutory amendments to deal with these problems. We understand that many banks would not like them, but we regret that the Department of the Treasury has simply chosen to ignore them. For our part, we intend our suggestions seriously. They are based on 50 years of expertise in the investment business and, we believe, a sound reading of history.

At our meeting on July 19, you asked us to identify problem areas in the bill and to submit corrective amendments. We are attaching a memorandum discussing specific legislative language to deal with each of them. As noted, most of the amendments have previously been endorsed by the Institute while others have not yet been approved by our Board. One, which envisages the concurrent repeal of Glass-Steagall and the McFadden Act, would obviously prove controversial to large segments of the affected industries. It is included, however, for the purpose of demonstrating the critical competitive interlock between these two laws, if we are indeed embarked on a road looking to the extinction of Glass-Steagall. Under those circumstances, competitive equity would demand that securities organizations whose natural genius lies in nationwide marketing should not be deprived of the ability to provide banking services through these systems if they are forced to compete with giant banks that have well worked-out interstate correspondent relationships.

Again, I would assure you of our sincere desire to work with the Department of the Treasury and the Congress in attempting to reach a consensus on the proposed legislation. The amendments we have suggested are not designed for any purpose other than to deal with the problems of public protection and competitive equity in a fair and balanced manner. We regret that the legislation proposed to date fails to meet these objectives.

We would be pleased to meet with you to discuss the specific concerns and suggestions set forth in the attached memorandum.

Sincerely yours,

David Silver

David Silver

Enclosures

SUMMARY OF PROPOSED AMENDMENTS

A - Place bank common trust funds and collective investment funds for retirement plans under the federal securities laws.

B - Place bank investment advisory services under the federal securities laws.

C - Place issuance of a bank's own securities and bank broker-dealer activities under the federal securities laws.

D - Prohibit a bank and its affiliated mutual fund from naving similar names.

E - Prohibit a bank from engaging in sales activities on behalf of its affiliated mutual fund.

F - Prohibit a bank and its affiliated mutual fund from having common personnel.

G - Strengthen current anti-tying provisions by prohibiting the tying of loans and trust services and by creating a presumption of unlawful tying where a significant number of bank trust or mutual fund customers receive other services from the bank.

H - Prohibit dumping of shares of the bank's affiliated mutual fund into fiduciary accounts managed by the bank.

I - Prohibit a bank affiliated mutual fund from investing in a company which is a borrower from the bank in order to facilitate repayment of loans to the bank. Also would prohibit a bank affiliated mutual fund from investing in securities issued or sold by other banks in the bank's correspondent system.

J - Prohibit a bank from making loans to a company in which the bank's affiliated mutual fund has invested in order to support the mutual fund.

K - Prohibit a bank from making loans to a customer to finance the customer's investment in the bank's affiliated mutual fund.

L - Permit all securities firms to engage in the banking business on a nation-wide basis and permit banks to engage in all securities activities.

M - Grant mutual fund sponsors trust powers upon the filing of certificates of election with the Comptroller of the Currency.

N - Strengthen the bill's restrictions on transactions between the bank and its securities affiliate.

O - Provide private rights of action for persons injured by violations of the Glass-Steagall Act.

P - Provide expedited treatment for reorganizations of mutual fund sponsors into holding companies, similar to the bill's treatment of reorganizations of banks into holding companies.

Q - Provide improved grandfather rights for companies owning a "non-bank" bank or a single thrift institution.

R - Extend the due process rights granted by the bill to banks to securities firms.

MAJOR DEFECTS IN THE PROPOSED FINANCIAL INSTITUTIONS DEREGULATION ACT OF 1983 AND SUGGESTED AMENDMENTS

INTRODUCTION

The Investment Company Institute submits this memorandum which identifies major deficiencies in the Treasury Department's proposed Financial Institutions Deregulation Act of 1983 and which suggests specific amendments designed to remedy them. The deficiencies in the bill can be grouped into three major categories.

First, although the bill ostensibly embodies the concept of "regulation by function," the bill totally fails to implement that concept by permitting banks to continue to engage in many securities activities outside the realm of the federal securities laws. Second, although the bill greatly expands the scope of permissible bank securities activities, the bill fails adequately to address the conflicts of interest, financial hazards and other abuses that are likely to result from these new activities. Third, although the bill purports to broaden the scope of permissible bank activities in order to enhance competition,* the bill in fact would create a playing field tilted sharply and unfairly in favor of large banks, at the expense of the members of the securities industry in general, and of the mutual fund industry in particular.

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* _See_ _Letter dated July 8, 1983, from Treasury Secretary Donald T. Regan to House Speaker Thomas P. O'Neill, Jr._ at 1.

This memorandum discusses each of these three problem areas seriatim, and suggests amendments to remedy the major deficiencies identified below.

I. REGULATION BY FUNCTION -- EXISTING BANK SECURITIES ACTIVITIES

The interrelated network of statutes currently applicable to the members of the financial services industry implicitly embodies the concept of "regulation by function." For although the statutes speak in terms of industry classifications -- "bank" versus "securities firms" versus "thrifts" -- those industry classifications themselves reflect the nature of the functions Congress intended these various types of regulated institutions to perform.

Thus, when Congress enacted the federal securities laws in the period 1933-1940, it exempted commercial banks from regulation under those laws because Congress believed that, by enacting the Glass-Steagall Act, it successfully had removed banks from virtually all aspects of the securities business. As the General Counsel of the Securities and Exchange Commission recently testified before the House Subcommittee on Commerce, Consumer and Monetary Affairs: "Since the Glass-Steagall Act was thought, as a general matter, to exclude banks from the securities business, the securities laws, in turn, exempt banks from most facets of securities regulation."*

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* *See* *Statement of Daniel L. Goelzer, General Counsel, Securities and Exchange Commission, Before the House Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations*, at 3-4 (July 20, 1983). *Accord* *Statement of K. Houston Matney, Chairman of Financial Institutions Committee of the North American Securities Administrators Association and Securities Commissioner of the State of Maryland Before the Senate Committee on Banking, Housing, and Urban Affairs*, at 5 (June 16, 1983).

However, over the ensuing decades, the nation's largest commercial banks have embarked upon major securities activities involving millions of investors and billions of dollars. Banks sponsor and distribute common trust funds and collective investment funds with assets of over $130 billion. Banks render investment advice to millions of investors and currently manage assets of over $689 billion, making banks the nation's largest money managers. Banks issue and distribute their own securities to the public. Banks perform brokerage services, sell third-party commercial paper and mass-market retail repurchase agreements. As a result of these activities, banks not only have eroded the principle of functional regulation underlying the existing statutory framework, but also conduct these and other securities activities completely free from regulation under the federal securities laws.

The advantages of, and the need to return to, a statutory scheme premised upon regulation by function have been well documented, and need not be repeated again here. As SEC Chairman Shad has explained, the allocation of regulatory jurisdiction by function is essential in order to assign to each regulatory agency jurisdiction over those economic functions it knows best, to permit the application of a consistent regulatory philosophy, to minimize regulatory conflicts, duplication, and overlap, and to establish the conditions for equal treatment of competitors.*

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* Hearings on S. 1720 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 97th Cong., 2nd Sess. 35 (1982) ("1982 Hearings") (Statement of SEC Chairman John S. R. Shad) ("Shad Statement").

The Department of the Treasury itself has recognized that any financial services industry legislation must return to the principle of regulation by function and must subject existing bank securities activities to regulation under the federal securities laws. Thus, in 1981 and 1982, Secretary Regan testified before the Senate Banking Committee and its Securities Subcommittee that, under the Treasury bill, any bank electing to create a securities affiliate would have to transfer "all other traditional securities business" and "all securities, brokerage, underwriting and dealing activities" carried on by the bank to the affiliate, and thereby subject these activities to regulation under the federal securities laws.*

However, the bill as presently drafted fails to implement Secretary Regan's stated program. For example, under the bill, commercial banks could continue to sponsor and distribute common trust funds and collective investment funds, render investment advice to millions of investors, mass-market the bank's own securities to the public, and perform securities brokerage activities completely free from regulation under the federal securities laws. The bill's failure to deal with bank common and collective funds is particularly surprising since SEC Chairman Shad recently stated that the bill "should be extended to require that the management of all collective investment vehicles -- including common trust funds and pooled employee benefit plans -- be carried out within a separate corporate affiliate."*

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* Hearings on S. 1686, S. 1703, S. 1720, and S. 1721 Before the Senate Committee on Banking, Housing, and Urban Affairs, Part I, 97th Cong., 1st Sess. 7 (1981) ("1981 Hearings Part I") (Statement of Treasury Secretary Donald T. Regan); 1982 Hearings at 3 (Statement of Treasury Secretary Donald T. Regan).

Three of the attached amendments would implement Secretary Regan's stated goal of requiring all bank securities activities to be conducted in separate affiliates and made subject to regulation under the federal securities laws.

-- Amendment A would amend the federal securities laws to delete the exemptions for bank common and collective funds and would require a bank to transfer its common and collective funds to a securities affiliate. This amendment would carry out Chairman Shad's specific proposal quoted above, a proposal previously endorsed by Governor Partee of the Federal Reserve Board.**

-- Amendment B would delete the exemptions in the federal securities laws for banks which act as investment advisers and would require a bank which establishes a securities affiliate to transfer its investment advisory activities to the affiliate. Former SEC Chairman Williams previously has proposed a similar approach.***

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* See Statement of John S. R. Shad, Chairman of the Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs at 20 (June 8, 1983).

** See 1982 Hearings at 42 (Statement of FRB Governor J. Charles Partee).

*** Hearings on H.R. 1539, H.R. 2747 and H.R. 2856 Before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking, Finance and Urban Affairs 96th Cong., 1st Sess. 17 (1979) (Statement of SEC Chairman Harold Williams).

-- Amendment C would amend the federal securities laws to delete the registration exemptions for securities issued by a bank or by a savings and loan association, would grant the SEC disclosure jurisdiction over the issuance of such bank securities, and would delete the exemptions in the securities laws for banks which act as brokers and dealers. Chairman Shad called for these precise reforms in his recent testimony before the Senate Banking Committee.*

II. PUBLIC PROTECTION

The Glass-Steagall Act represents Congress' considered legislative judgment that "policies of competition, convenience or expertise which might otherwise support the entry of commercial banks into the investment [company] business [are] outweighed by the 'hazards' and 'financial dangers' that arise" when commercial banks engage in that business.** The history of bank sponsorship of investment trusts in the 1920s and subsequent bank sponsorship of other pooled investment vehicles (*e.g.*, bank sponsorship of real estate investment trusts in the early 1970s and current-day bank sponsorship of common and collective funds) confirms the wisdom of that judgment.*** It also highlights the unique public protection issues raised by the Department's proposal to reverse that judgment and to permit banks to sponsor mutual funds through affiliates of their parent holding companies.

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* *Shad Statement* at 12, 15.

** *Investment Company Institute* v. *Camp*, 401 U.S. 617, 630 (1971) ("Camp").

*** Indeed, following the debacle of the 1920s, bankers themselves testified that the problems associated with bank and bank affiliate sponsorship of investment companies were so great that these activities should be totally prohibited in the future. *See*, *e.g.*, *Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies Part III*, at 136, 179 (1939-1940) (Statement of the Chairman, Chatham Phoenix National Bank and Trust Company of New York, and the President, Central Trust Company of Illinois).

Secretary Regan himself has recognized that bank affiliate mutual fund activity "does raise all the traditional Glass-Steagall concerns".* Especially in light of this concession, it is incumbent upon the Department to ensure that any legislation repealing the Glass-Steagall Act contains safeguards adequate to address and ameliorate all these "traditional Glass-Steagall concerns." While Secretary Regan has expressed the belief that "our proposed legislation, in company with existing banking and securities laws, provides adequate safeguards,"** history and the cumulative experience of numerous experts in this area proves otherwise.

As Chairman Garn and others have repeatedly pointed out, the mere creation of an affiliate does not, and cannot, eradicate the myriad conflicts of interests, financial dangers, and other abuses which existed in the 1920s or which developed in connection with bank sponsored REITs during the 1970s. Moreover, the banking laws cannot provide adequate safeguards against these dangers, since the banking laws, according to the federal banking regulators, are designed solely to insure the safety and soundness of the banking system, and not to protect investors.***

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* 1982 Hearings at 6 (Statement of Treasury Secretary Donald T. Regan).

** Id.

*** See, e.g., A. G. Becker Incorporated v. Board of Governors, 693 F.2d 136 (D.C. Cir. 1982), petition for cert. filed, No. 82-1766 (April 29, 1983).

Finally, the existing securities laws cannot provide adequate safeguards because they are premised upon the assumption that the activities regulated thereunder are forbidden to banks.

For example, the Investment Company Act was enacted by Congress to deal with the unique and specific conflicts which arise when investment banking firms, brokerage firms and investment advisers sponsor, manage and distribute the shares of mutual funds.* However, because Congress believed that it successfully had excluded banks from the investment company business, the Act does not purport to deal with the unique conflicts of interest which result when commercial banks or their affiliates engage in the mutual funds business. As SEC Chairman Shad has testified:

> [t]he Investment Company Act was adopted after the Glass-Steagall Act separated commercial banking from investment banking. Therefore, the Investment Company Act could not address the problem of bank conflicts of interest specifically.**

In short, if affiliates of commercial banks are to be permitted to organize, sponsor and distribute the shares of mutual funds, it will be necessary to revise the Investment Company Act to deal with the unique conflicts of interest which will result.

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* The typical pattern used in the 1940 Act is to prohibit specific types of potential conflict of interest transactions involving specific types of firms, while authorizing the SEC to issue exemptive orders and rules in appropriate cases.

** Hearings on S. 1686, S. 1703, S. 1720, and S. 1721 Before the Senate Committee on Banking, Housing, and Urban Affairs, Part II, 97th Cong., 1st Sess. 914 (1981) ("1981 Hearings Part II") (Statement of SEC Chairman John S. R. Shad).

Attached are a number of amendments which address the major hazards which have been identified by Chairman Shad, Chairman Volcker, Governor Partee and other witnesses, and which have occurred in the past when banks and their affiliates sponsored pooled investment vehicles.

-- Amendment D would prohibit a bank, its securities affiliate and any related mutual fund from having similar names. This amendment, which specifically was suggested by Chairman Volcker,* is designed to prevent public confusion between the bank and its affiliated mutual fund.

-- Amendment E is also designed to prevent public confusion by prohibiting a bank, among other things, from:

> distributing prospectuses or sales literature relating to its affiliated mutual fund;
>
> rendering investment advice to the public with respect to the advisability of investing in its affiliated mutual fund;
>
> furnishing the names of its depositors to its affiliated mutual fund or its securities affiliate; and
>
> maintaining its offices in any building which is likely to be identified by the public with its affiliated mutual fund.

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* 1981 Hearings Part II at 466 (Statement of FRB Chairman Paul Volcker). Accord 1982 Hearings at 89 (Statement of Robert Charles Clark, Professor, Harvard Law School) (The bill "should prevent affiliates from having names that are substantially similar to that of the member bank. Merely telling bank holding companies not to lie, not to affirmatively mislead people, is not enough to prevent identity confusion of the sort that's of concern here, and letting affiliates have similar names will increase the chance of confusion").

It should be noted that this amendment is based on the restrictions contained in present Federal Reserve Board Regulation Y governing the relationship between closed-end investment companies and their bank holding company subsidiary investment advisers.*

-- Amendment F would recodify Section 32 of the Glass-Steagall Act to require that a bank have different officers, directors and employees than its securities affiliate and affiliated mutual fund, while expanding its reach to include all depository institutions and not merely Federal Reserve System member banks. This amendment is designed both to prevent public confusion and to strengthen the separation between the bank and its securities affiliate and affiliated mutual fund. Indeed, following the debacle of the 1920s, bankers themselves testified that major problems were created when banks, their securities affiliates and investment companies shared the same officers.**

-- Amendment G would amend the anti-tying provisions of the Bank Holding Company Act and the Home Owners' Loan Act to prohibit a bank from tying the granting of credit to a customer's acquisition of trust services. The amendment would also extend the anti-tying provisions to include securities affiliates as well as banks themselves. In addition, the amendment would address the difficult problems of proof presented under current law* by codifying a presumption that a bank or its securities affiliate has engaged in unlawful tying arrangements whenever a significant number of the bank's trust customers at the same time receive other services from the bank or its affiliates, or when a significant number of a securities affiliate's mutual fund customers at the same time receive other services from the bank or its affiliates. Finally, Amendment G preserves the private right of action for trade associations to redress violations of the tying prohibitions of the Bank Holding Company Act and the Home Owners' Loan Act presently contained in the bill. In this respect, it should be noted that Senators D'Amato and Hecht,** SEC Chairman Shad*** and Assistant Attorney General

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* See 12 C.F.R. §225.125 (1983).

** See Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies, supra, at 179 (Statement of the President, Central Trust Company of Illinois) ("Any conscientious officer will try to administer each of those three companies for its own best interest. As long as your security market is stable or inclining upward, as long as you are in a period of reasonable prosperity, I feel that that sort of relationship is endurable. But, once the reverse takes place, then your officers are in constant embarrassment").

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* See, e.g., Transcript of Hearings Before the House Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce at 52 (June 16, 1983) (Statement of SEC Chairman John S. R. Shad) ("[T]here are prohibitions against tie-ins, but they are extremely difficult to police, whether or not it is implicit when a bank makes a loan that it is going to do take-out financing for instance").

** Transcript of Hearings on Conditions in the Financial Institutions Industry Before The Senate Committee on Banking, Housing, and Urban Affairs at 37-38, 42-44 (April 6, 1983).

*** See Transcript of Hearings on Finance Institutions Industry Before the Senate Committee on Banking, Housing, and Urban Affairs at 71-73 (June 8, 1983) (Statement of SEC Chairman John S. R. Shad).

Baxter* all have identified the tying of loans to the provision of other products and services as an area of major concern.

-- Amendment H would prevent banks from "dumping" securities issued by their affiliated mutual funds into bank-managed trust accounts by prohibiting a bank from causing an account which it manages in a fiduciary capacity from purchasing shares of the bank's affiliated mutual fund, unless such purchase has been ordered by a court or is permitted by an SEC order or rule. The practices of "dumping" securities into bank trust accounts was one of the abuses that prompted the enactment of the Glass-Steagall Act,** and Senator Gorton recently expressed his concern that the bill contain provisions adequate to prevent any repetition of this practice.***

-- Amendment I would prohibit a mutual fund sponsored by a bank securities affiliate from investing in a company which is a borrower from the bank in order to facilitate repayment of the loans to the bank, with the SEC given the authority to issue exemptive orders and rules in appropriate cases. This abuse arose when banks and their affiliates sponsored investment companies in the 1920s,**** and was a major factor leading to the passage of the Glass-Steagall Act.* SEC Chairman Shad, in referring recently to this "most basic potential conflict of interest,"** suggested that Congress consider enacting specific provisions to ensure against any reoccurrence of this practice.***

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* Id. at 105-106 (Testimony of William F. Baxter, Assistant Attorney General, Antitrust Division, Department of Justice).

** See Camp supra, 401 U.S. at 633.

*** See Transcript of Hearings on Moratorium Legislation and Financial Institutions Deregulation Before the Senate Committee on Banking, Housing, and Urban Affairs at 49-53 (July 18, 1983).

**** See Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies, supra, at 127.

Amendment I also would prohibit a bank from causing its mutual fund to purchase securities issued or sold by other banks in its correspondent system, with the SEC given authority to exempt such purchases in appropriate cases. This was an area of abuse in the 1920s when larger banks caused their affiliated investment companies to make such investments in order to enhance the bank's role as correspondent to smaller banks.****

-- Amendment J would prohibit a bank from making loans to a company in which the bank's affiliated mutual fund had invested in order to support the mutual fund, with the SEC given broad exemptive authority. This specific area of abuse again was one which prompted Congress to enact the Glass-Steagall Act.*

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* See Camp, supra, 401 U.S. at 631.

** See 1981 Hearings Part II at 914 (Statement of SEC Chairman John S. R. Shad) ("[P]erhaps the most basic potential conflict of interest of a bank is that between its interests as a creditor of a corporation to which it had made a commercial loan and its duty to consider the best interests of any investment company it managed in any situation where the investment company owned or considered purchasing securities issued by the same corporation").

*** Id. at 915.

**** See Report of Securities and Exchange Commission on In-Investment Companies and Investment Trusts, supra, at 167.

-- Amendment K would prohibit a bank from making loans to a customer in order to finance the customer's investment in the bank's affiliated mutual fund, with the SEC given broad exemptive powers. As the Supreme Court has recognized, the history of bank investment company activities in the 1920's reveals that the promotional pressures of the securities business often tempted banks to engage in this misapplication of bank assets, with a resulting loss of public confidence in the bank when the customer suffered losses on the bank affiliate's securities.**

III. COMPETITIVE EQUITY

Although the Treasury Department has stated that the bill is intended to enhance competition in the financial services industry, enactment of the bill in its present form can only lead to the opposite result. Recent experience indicates that, rather than creating their own mutual fund organizations, large banks will simply buy existing large mutual fund organizations, thereby accelerating concentration. For example, when Bank of America recently decided to enter the discount brokerage business, it did not start a discount brokerage operation from scratch or even buy and then expand a small discount broker. Instead, the nation's largest bank simply bought the nation's largest discount broker.

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* Camp, supra, 401 U.S. at 631.

** Id. at 632.

Moreover, the bill is a one-way street. Although all banks, including the largest and most powerful ones, would be authorized under the bill to enter the mutual fund business, the nation's largest securities firms would continue to be prohibited from entering the banking business due to their corporate underwriting activities. Even those securities firms which could enter the banking business would be placed at a competitive disadvantage, because they then would face unfair competition from banking giants who already have grown and prospered under the special protections afforded by the banking laws--protections such as restricted entry into the banking business by would-be competitors; the geographical safe-harbors and "captive" correspondent systems resulting from the McFadden Act and the Douglas Amendment; monopoly profits from price fixed rates of return (Regulation Q); subsidization from cheap deposits (the prohibition against paying interest on demand deposits); limitation of competition among banks based on risk (FDIC insurance); and bank freedom from public disclosure under the federal securities laws.

In theory fair competition between securities firms and commercial banks could be achieved by redrafting the bill to do away with each and every one of the special privileges accorded to commercial banks. However, the Department of Treasury has not expressed the intention of making such wide-ranging changes in the banking laws nor would they seem to be desirable. Under these circumstances, the most appropriate course of action would

would be simply to repeal the Glass-Steagall Act, and thereby to permit all securities firms to enter the banking business while permitting banks to enter the full securities business.

Even this approach, however, would not produce a fair field of competition. The restrictions on geographical expansion contained in the McFadden Act and the Douglas Amendment to the Bank Holding Company Act have led to a well developed nationwide correspondent system of banks through which the largest banks provide numerous services to "captive" smaller banks and in turn to their customers. As was recently recognized:

> Correspondent relationships with "country banks" provide [major banks] another captive market. Major banks offer their correspondents services such as check clearing, loan participations, lines of credit and investment advice in return for deposit balances. A natural allegiance to the respondents arises from this relationship....*

The large banks have made it clear that, if the Glass-Steagall Act is modified to permit bank affiliates to sponsor mutual funds, they intend to utilize these correspondent relationships to distribute the shares of their funds through their well-established chains of local banks. In each community these securities activities will be linked to the banking services provided by local banks to their banking customers. Thus, modification of the Glass-Steagall Act to permit bank affiliates to sponsor mutual funds will give the large banks a major competitive advantage over traditional securities firms. This advantage will exist even if securities firms are permitted to exercise full banking powers in a single state since, as new entrants into the banking business, securities firms would be outside this correspondent system which has grown in the protectionist shelter of the McFadden Act and the Douglas Amendment. This competitive disadvantage can only be ameliorated by permitting securities firms to engage in multi-state banking activities.

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* Mehle, Bank Underwriting of Municipal Revenue Bonds: Preserving Free and Fair Competition, 26 Syracuse L. Rev. 1117, 1145 (1975).

-- Amendment L would deal with these problems by adding the underwriting of corporate securities to the list of permissible activities for securities affiliates and by repealing the McFadden Act and the Douglas Amendment to the Bank Holding Company Act.

We note that we offered a similar amendment when we testified regarding the Department's earlier bill.* We must assume, however, that the lack of response from the Department regarding our proposal indicates the Department is intent on seeking legislation which simply would provide a one-way street for large bank entry into the mutual fund business. If this is indeed the Department's intent, we would urge the adoption of at least the following provisions in order to try to bring some balance into what would be an extremely inequitable competitive situation.

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* 1982 Hearings at 414-15 (Statement of David Silver).

-- Amendment M would grant investment advisers to mutual funds trust powers upon the filing of certificates of election with the Comptroller of the Currency. Absent such a provision, Section 7 of the bill would prevent many members of the mutual fund industry from acquiring trust powers due to the mechanical application of the Bank Holding Company Act. In this connection it is essential to bear in mind that there is no logical connection between the business of banking and the rendering of trust services.*

-- Amendment N would amend the Department's proposed Section 23B of the Federal Reserve Act to prohibit loans, sales of securities, and other transactions between a bank and its securities affiliate unless the Federal Reserve Board first has determined that the terms of such transactions are comparable to those that would be extended to non-affiliated companies. Amendment N also would extend the reach of the Department's proposed Section 23B to encompass all depository institutions. Amendment N also would make clear that nothing in Section 23B shall affect or amend any provision of the Investment Company Act of 1940. Consistent with the terms of our proposed amendments D and H, Amendment N also would prohibit a bank and its securities affiliate and related mutual fund from using similar names, and would prohibit the "dumping" of securities into bank-managed trust accounts. Amendment N is designed to ensure that a bank securities affiliate receives no unfair advantage of any kind by virtue of its association with the bank.

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* _See_ Scott, _Fifty Years of Trusts_, 50 _Harv. L. Rev._ 60, 62 (1936) ("It was perhaps something of an accident that the corporations which have obtained power to administer trusts are banking institutions. There is no necessary connection between the business of banking and the business of administering trusts. Indeed, many difficulties have arisen from the attempt to combine these two powers").

-- Amendment O would provide private rights of action for persons injured by violations of the Glass-Steagall Act. Although the courts have recognized the existence of an implied right of action under the Glass-Steagall Act on behalf of injured bank competitors,* this right of action should be expressly codified to ensure against claims that Congress intended those injured by unlawful bank conduct to have no judicial redress at all.

-- Amendment P would provide expedited treatment for reorganizations of mutual fund sponsors into holding companies. The bill presently provides expedited treatment for banks seeking to reorganize into holding company patterns, but fails to provide the same benefit to mutual fund firms. We are uncertain whether this omission is another example of the bill's one way street bias, or whether the omission is inadvertent. In either event, it should be corrected so that banks and mutual fund organizations are afforded equal treatment.

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* See, e.g., New York Stock Exchange, Inc. v. Bloom, 562 F.2d 736, 742, 742 n. 5 (D.C. Cir. 1977), cert. denied, 435 U.S. 942 (1978); American Society of Travel Agents, Inc. v. Bank of America National Trust & Savings Association, 385 F.Supp. 1084 (N.D. Cal. 1974).

-- Amendment Q would provide improved grandfather privileges to any company owning a "non-bank" bank or a single thrift institution by striking the provision prohibiting such companies from engaging in any new activity subsequent to July 1, 1983 which is not permissible for a bank or savings and loan holding company, and by granting to the appropriate depository institution regulatory agency the authority to extend any forfeited grandfather privileges, in the public interest, for a period not to exceed one year. The requirement that a grandfathered non-bank or unitary savings and loan company refrain from engaging in any new activity not permissible for a holding company serves no legitimate purpose, would straightjacket existing securities firms, and is anticompetitive. The absence of authority to extend the grandfather privileges of securities firms is equally anticompetitive, since the bill grants such extensions to thrift service corporations engaged in the securities business.

-- Amendment R would extend the due process rights granted by the bill to banks and thrifts to all interested persons. As presently drafted, the bill is one-sided in extending to depository institutions the right to participate in agency proceedings and to obtain judicial review thereof, while expressly denying those same rights to members of the securities industry.

CONCLUSION

In conclusion, we simply wish to reiterate our disappointment that, although we offered a number of specific amendments which addressed many of the issues discussed in this memorandum in testimony before Congress in both 1981 and 1982,* the Department of the Treasury, with minor exceptions, simply has ignored our suggestions. We are hopeful that, on this occasion, the Department will carefully consider and accept the specific suggestions set forth in this memorandum.

The lessons of history teach that, given the inherent conflicts of interest and other hazards that arise when banks engage in the securities business, it simply will not do merely to amend the Glass-Steagall Act now and hope for the best in the future. As Professor James L. Pierce, Professor of Economics, University of California, recently warned:

> [N]ow is the time to build in safeguards rather than to wait until abuses appear. I fear that far too little has gone into designing safeguards and I know that the various pieces of proposed legislation before Congress pay scant attention to this problem.**

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* See 1982 Hearings at 399-415 (Statement of David Silver); 1981 Hearings Part I at 839-53 (Statement of David Silver).

** Statement of James L. Pierce, Professor of Economics, University of California, Before the House Committee on Banking, Finance and Urban Affairs on Financial Institutions in a Revolutionary Era, 97th Cong., 1st Sess. 11 (Dec. 10, 1981).

A. PLACING BANK COMMON TRUST FUNDS AND COLLECTIVE INVESTMENT FUNDS UNDER THE FEDERAL SECURITIES LAWS

Amendments to the Securities Act of 1933

Sec. 26. Section 3(a)(2) of the Securities Act of 1933, as amended (15 U.S.C. 77c (a)(2)), is hereby amended by deleting, after the words "a Federal Reserve Bank", the words: "or any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian"; and by deleting, after the words "a single trust fund", the words "or in a collective trust fund maintained by a bank"; by deleting from the last sentence thereof the words: "a security issued or guaranteed by a bank shall not include any interest or participation in any collective trust fund maintained by a bank"; and by deleting from the last sentence thereof the words: "except that in the case of a common trust fund or similar fund or a collective trust fund, the term 'bank' has the same meaning as in the Investment Company Act of 1940."

Amendments to the Securities Exchange Act of 1934

Sec. 27. Section 3(a)(12) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78c (a)(12)), is hereby amended by deleting the words: "any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian"; and by deleting the words: "or a collective trust fund maintained by a bank."

Amendments to the Investment Company Act of 1940

Sec. 28. Section 3(c)(3) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-3(c)(3)), is hereby amended by deleting the words: "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian."

Sec. 29. Section 3(c)(11) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-3(c)(11)), is hereby amended by deleting the words: "or any collective trust fund maintained by a bank consisting solely of assets of such trusts."

B. PLACING BANK INVESTMENT ADVISORY ACTIVITIES UNDER THE FEDERAL SECURITIES LAWS

Amendments to the Investment Advisers Act of 1940

Sec. 30. Section 202(a)(11) of the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-2(a)(11)), is hereby amended by deleting the words "(A) any bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company," and by renumbering subparagraphs "(B)", "(C)", "(D)", "(E)", and "(F)" of Section 202(a)(11) as "(A)", "(B)", "(C)", "(D)", and "(E)", respectively.

Amendments to the Bank Holding Company Act

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration Proposal are in Brackets]

Sec. 11. Subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)), is hereby amended by deleting the penultimate sentence thereof and by adding a new paragraph (15) as follows: "(15) shares of any depository institution securities affiliate engaged in activities in accordance with the limitations contained in this paragraph:

"(i) No depository institution holding company that establishes or acquires any depository institution securities affiliate pursuant to this paragraph shall, after one year from the date on which any such depository institution securities affiliate first engages in any of the activities authorized under subparagraph (iii) of this paragraph, permit any depository institution controlled by such depository institution holding company to engage, directly or through a subsidiary, in the United States in any of the activities authorized under such subparagraph (iii) of this paragraph or any of the following activities, which are authorized pursuant to paragraph Seventh of Section 5136 of the

Revised Statutes of the United States, as amended (12 U.S.C. 24): dealing in and underwriting obligations of the United States, general obligations of any state of the United States or any political subdivision thereof and other obligations listed in paragraph Seventh of such Section 5136, [and] purchasing and selling securities and stock as agent[.], and acting as an investment adviser as defined in Section 202(a)(11) of the Investment Advisers Act of 1940, as amended. For purposes of this paragraph the Board may, by regulation or order, determine other securities or securities-related activities in which depository institutions may not engage. No rule, regulation or order of the Board, however, shall prohibit a depository institution from engaging in those securities or securities-related activities that are necessary or incidental to the financing of such depository institution or the investment of its funds. In the event that a depository institution holding company terminates all of the activities specified in subparagraph (iii) of this paragraph of its depository institution securities affiliate, any depository institution subsidiary of such holding company may conduct, directly or through a subsidiary, any securities or securities-related activities that it is authorized by law to conduct.

* * *

"(iii) In addition to the activities referred to in subparagraphs (i) and (ii) of this paragraph, such depository institution securities affiliate may --

> "(A) deal in and underwrite all obligations issued or guaranteed by or on behalf of a state or any political subdivision thereof or any agency or instrumentality of either of the foregoing, except industrial development bonds as defined in section 103(b)(2) of the Internal Revenue Code of 1954, as amended; provided, however, that depository institution securities affiliates may deal in and underwrite such industrial development bonds, the interest on which is exempt from Federal income tax under

section 103(a) of the Internal Revenue Code of 1954, as amended, if: (1) a state, territory, possession of the United States, or any political subdivision of the foregoing, or the District of Columbia pledges its full faith and credit for the payment of all principal and interest on such bonds or (ii) the issuer, or the state or local governmental unit on behalf of which the industrial development bonds were issued, is considered the sole owner, for Federal income tax purposes, of the facility with respect to which financing is to be provided from the proceeds of such industrial development bonds;

"(B) organize, sponsor, operate, and control an investment company, as such term is defined in Section 3 of the Investment Company Act of 1940, as amended;

"(C) [render investment advice] act as investment adviser to[: (1) an investment company as described in subparagraph (B) above; and (2) any investment company other than a closed-end investment company] any investment company, as such terms are defined in Section 202(a)(11) of the Investment Advisers Act of 1940, as amended, and Section 3 of the Investment Company Act, as amended;

"(D) underwrite, distribute, and sell securities of any investment company, as such terms are defined in Section 3 of the Investment Company Act of 1940, as amended.

* * *

C. REPEAL OF EXISTING FEDERAL SECURITIES LAWS EXEMPTIONS FOR BANK SECURITIES AND BANK BROKER-DEALER ACTIVITIES

Amendments to the Securities Act of 1933

Sec. 31. Section 3(a)(2) of the Securities Act of 1933, as amended (15 U.S.C. 77c(a)(2)), is hereby amended by deleting after the words "or any certificate of deposit for any of the foregoing" the following: "or any security issued or guaranteed by a bank".

Sec. 32. Section 3(a) of the Securities Act of 1933, as amended (15 U.S.C. 77c (a)), is hereby amended by deleting subsection (5) in its entirety.

Amendments to the Securities Exchange Act of 1934

Sec. 33. Section 12 of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78l), is hereby amended by deletting subsection (i) in its entirety.

Sec. 34. Section 3(a)(4) and Section 3(a)(5) of the Securities Exchange Act of 1934, as amended (15 U.S.C. §§78c(a)(4), 78c (a)(5)), are hereby amended by deleting therefrom the phrase "but does not include a bank."

D. PROHIBITION AGAINST USE OF A BANK'S NAME BY ITS SECURITIES AFFILIATE AND AFFILIATED MUTUAL FUND

Amendments to the Investment Company Act of 1940

Sec. 35. Section 35(d) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-34(d)), is hereby amended by adding the following language after the first sentence: "It is hereby declared to be deceptive and misleading for any depository institution securities affiliate or any regitered investment company which is organized, sponsored, operated or controlled by, or which receives investment advice from, a depository institution securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended, or the Savings and Loan Holding ComCompany Amendments of 1967, as amended, of to adopt, as a part of the name or title of such company, or of any security of which it is the issuer, any words or words which are the same as, similar to, or a variation of, the name of any depository institution holding company, any depository institution or any other subsidiary of a depository institution holding company which is affiliated with such depository institution securities affiliate."

Amendments to the Federal Reserve Act

[Additions to the Administration Proposal are Underlined; Deletions From the Administration Proposal are in Brackets]

Sec. 15. (a) The Federal Reserve Act is amended by adding new Section 23B immediately following Section 23A (12 U.S.C. 371c) thereof to read as follows:

* * *

"(b) A member bank and the affiliates of such bank shall not publish any advertisement or enter into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates[; however, a member bank and its affiliates may use similar names].

* * *

E. LESSENING OF PUBLIC CONFUSION BETWEEN BANKING FUNCTIONS AND AFFILIATED MUTUAL FUND ACTIVITIES

Amendments to the Investment Company Act of 1940

Sec. 36. Section 35 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-34), is hereby amended by adding the following new paragraph: "(e) It shall be unlawful for any depository institution which is affiliated with a depository institution securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended, or as defined in the Savings and Loan Holding Company Amendments of 1967, as amended, or for any affiliated person of such depository institution other than such a depository institution securities affiliate, to engage, directly or indirectly, in the offer or sale of any securities issued by any investment company which is organized, sponsored, operated or controlled by, or which receives investment advice from, such depository institution securities affiliate. For purposes of this section, the term 'engage, directly or indirectly, in the offer or sale of securities of an investment company' shall include promoting or advertising such investment company or the securities issued by such investment company; distributing or making available prospectuses or sales literature relating to securities issued by such investment company; referring any custotomers or business to such investment company or such depository institution securities affiliate; rendering investment advice with respect to the advisability of investing in securities issued by such investment company; furnishing the names of depositors in such depository institution to such investment company or such depository institution securities affiliate; and the maintenance of offices by such investment company in any building which is likely to be identified with such depository institution or any affiliated person of such depository institution other than such depository institution securities affiliate."

F. PROHIBITION AGAINST OVERLAPPING PERSONNEL

Amendments to the Banking Act of 1933

[Additions to the Existing Statutory Language Are Underlined; Deletions From the Existing Statutory Language Are In Brackets.]

Sec. 37. Section 32 of the Banking Act of 1933, as amended (12 U.S.C. 78), is hereby amended to read as follows:

No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve at the same time as an officer, director, of employee of any [member bank] depository institution. [except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.]

The term 'depository institution' as used in this section has the meaning ascribed to it by Section 1841(k)(2) of this Title (12 U.S.C. 1841(k)(2)) and Section 1730a(a)(1)(K)(ii) of this Title (12 U.S.C. 1730a(a)(1)(K)(ii)), and includes an uninsured institution as defined in Section 1730a(a)(1)(B) of this Title (12 U.S.C. 1730a(a)(1)(B)).

G. STRENGTHENED ANTI-TYING PROVISIONS

Amendments to the Bank Holding Company Act Amendments of 1970

[Additions to the Existing Statutory Language or the Administration's Proposal are Underlined; Deletions are in Brackets]

Sec. 38. Subsection 106(b) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972(i)) is hereby amended to read as follows:

(1) A bank or its depository institution securities affiliate shall not in any manner extend credit, lease or sell property of any kind, or furnish any service, or fix or vary the consideration for any of the foregoing, on the condition or requirement --

> (A) that the customer shall obtain some additional credit, property, or service from such bank or from such depository institution securities affiliate other than a loan, discount, or deposit[, or trust service];
>
> (B) that the customer shall obtain some additional credit, property, or service from a bank holding company of such bank or from any other subsidiary of such bank holding company, including a depository institution securities affiliate;
>
> (C) that the customer provide some additional credit, property, or service to such bank or such depository institution securities affiliate, other than those related to and usually provided in connection with a loan, discount, or deposit[, or trust service];
>
> (D) that the customer provide some additional credit, property, or service to a bank holding company of such bank or to any other subsidiary of such bank holding company, including a depository institution securities affiliate;

(E) that the customer shall not obtain some other credit, property, or service from a competitor of such bank, a bank holding company of such bank, or any subsidiary of such bank holding company, including a depository institution securities affiliate, other than a condition or requirement that such bank shall reasonably impose in a credit transaction to assure the soundness of the credit.

[The Board may by regulation or order permit such exceptions to the foregoing prohibition as it considers will not be contrary to the purposes of this chapter.] If a significant number of customers of any bank receive trust services from such bank and at the same time receive other credit, property, or services from such bank, from a holding company of such bank or from any other subsidiary of such holding company, including a depository institution securities affiliate, it shall be presumed that such bank obtained the trust business of all such customers in violation of this section. In addition, if a significant number of customers of any depository institution securities affiliate own securities of any registered investment company organized, sponsored, operated, controlled, or advised by such depository institution securities affiliate, and at the same time receive other credit, property, or services from such depository institution securities affiliate, from a holding company of such depository institution securities affiliate, or from any other subsidiary of such holding company, including a depository institution, it shall be presumed that the securities owned by all such customers were sold to such customers in violation of this section.

Sec. 17. Section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972, et seq.) is hereby amended by adding new subsection (i) at the end thereof to read as follows:

"ACTIONS AUTHORIZED TO BE COMMENCED BY TRADE ASSOCIATIONS

"Any action for injunctive relief that may be commenced by any person pursuant to Section 1976 of this title, may be commenced on the behalf of such person by any trade association of which such person is a member, provided that any such action commenced by a trade association shall be subject to the same requirements, limitations, and conditions as would be applicable had such action been commenced by any such person pursuant to section 1976 of this title.".

Amendments to the Home Owners' Loan Act of 1933

[Additions to the Existing Statutory Language or the Administration's Proposal are Underlined; Deletions are in Brackets]

Sec. 24. Subsection 5(q) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464 (q)) is amended --

(1) by amending subsection 5(q)(1) to read as follows:

(q)(1) An association or its depository institution securities affiliate shall not in any manner extend credit, lease or sell property of any kind, or or furnish any service, or fix or vary the consideration for any of the foregoing, on the condition or requirement --

(A) that the customer shall obtain additional credit, property, or service from such association or from any service corporation or affiliate of such association, including a depository institution securities affiliate, other than a loan, discount, or deposit[, or trust service];

(B) that the customer provide additional credit, property, or service to such association, or to any service corporation or affiliate of such association, including a depository institution securities affiliate, other than those related to and usually provided in connection with a similar loan, discount, or deposit[, or trust service]; and

(C) that the customer shall not obtain some other credit, property, or service from a competitor of such association, or from a competitor of any service corporation or affiliate of such association, including a depository institution securities affiliate, other than a condition or requirement that such association shall reasonably impose in connection with credit transactions to assure the soundess of credit.

If a significant number of customers of any association receive trust services from such association and at the same time receive other credit, property or services from such association, from a holding company of such association, or from any other subsidiary of such holding company, including a depository institution securities affiliate, it shall be presumed that such association obtained the trust business of all such customers in violation of this section. In addition, if a significant number of customers of any depository institution securities affiliate own securities of any registered investment company organized, sponsored, operated, controlled, or advised by such depository institution securities affiliate, and at the same time receive other credit, property, or services from such depository institution securities affiliate, from a holding company of such depository institution securities affiliate, or from any other subsidary of such holding company, including an association, it shall be presumed that the securities owned by all such customers were sold to such customers in violation of this section.

(2) by adding a new paragraph (6) to read as follows:

"(6) Any action for injunctive relief that may be commenced by any person pursuant to paragraph (2) of this provision, may be commenced on the behalf of such person by any trade association of which such person is a member, provided that any such action commenced by a trade association shall be subject to the same requirements, limitations and conditions as would be applicable had such action been commenced by any such person pursuant to paragraph (2) of this provision.".

H. PROHIBITION AGAINST DUMPING OF AFFILIATED MUTUAL FUND SECURITIES INTO BANK FIDUCIARY ACCOUNTS

Amendments to the Investment Company Act of 1940

Sec. 39. Section 17 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-17), is hereby amended by adding the following new paragraph:

"(k) It shall be unlawful for any affiliated person of any depository institution securities affiliate, as defined in Section 1841(j) and Section 1730a(a)(1)(K) of Title 12 of the United States Code, to purchase as fiduciary any securities issued by any registered investment company which is organized, sponsored, operated, or controlled by such depository institution securities affiliate, or which receives investment advice from such depository institution securities affiliate, unless such purchases are required by court order. The Commission may, by rules, and regulations or order permit such purchases which the Commission deems to be in the public interest and consistent with the protection of investors, and the terms of which the Commission determines to be reasonable and fair and not to involve overreaching on the part of any person concerned."

I. PROHIBITION AGAINST MANIPULATION OF AFFILIATED MUTUAL FUND TO FACILITATE LOAN REPAYMENTS TO BANKS OR TO ASSIST CORRESPONDENT BANKS

Amendments to the Investment Company Act of 1940

Sec. 40. Section 17 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-17), is hereby amended by adding the following new paragraph:

"(1) It shall be unlawful for any depository institution securities affiliate, as defined in Section 1841(j) and Section 1730a(a)(1)(K) of Title 12 of the United States Code, to cause any registered investment company which is sponsored, organized, operated or controlled by, or which receives investment advice from, such depository institution securities affiliate (1) to purchase any security issued by any issuer who was indebted at any time during such issuer's last fiscal year to any depository institution holding company company, any depository institution, or any other subsidiary of a depository institution holding company which is affiliated with such depository institution securities affiliate; and (2) to purchase any security or other property issued or sold as principal, by any depository institution which regularly receives correspondent services from any depository institution holding company, any depository institution or any other subsidiary of a depository institution holding company which is affiliated with such depository institution securities affiliate. For the purposes of this section, the term 'correspondent services' includes the acceptance of deposits and the performing of other banking or depository services. The Commission may, by rules and regulations or order, permit such purchases which the Commission deems to be in the public interest and consistent with the protection of investors, and the terms which the Commission determines to be fair and reasonable and not to involve overreaching on the part of any person concerned."

J. PROHIBITION AGAINST BANK LOANS TO SECURITIES ISSUERS TO SUPPORT AFFILIATED MUTUAL FUNDS

Amendments to the Investment Company Act of 1940

Sec. 41. Section 17 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-17), is hereby amended by adding the following new paragraph:

"(m) It shall be unlawful for any affiliated person of any depository institution securities affiliate, as defined in Sections 1841(j) and 1730a(a)(1)(K) of Title 12 of the United States Code, to lend any money, securities, or other property to any issuer any of whose outstanding securities are owned by any registered investment company organized, sponsored, operated, controlled or advised by such depository institution securities affiliate. The Commission may, by rules and regulations or order, permit such loans which the Commission deems to be in the public interest and consistent with the protection of investors, and the terms of which the Commission determines to be fair and reasonable and not to involve overreaching on the part of any person concerned."

K. PROHIBITION AGAINST LOANS BY BANKS TO ENABLE CUSTOMERS TO PURCHASE SECURITIES OF AFFILIATED MUTUAL FUNDS

Amendments to the Investment Company Act of 1940

Sec. 42. Section 17 of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-17), is hereby amended by adding the following new paragraph:

"(n) It shall be unlawful for any affiliated person of any depository institution securities affiliate, as defined in Sections 1841(j) and 1730a(a)(1)(K) of Title 12 of the United States Code, to lend any money to any person to enable such person to purchase securities issued by a registered investment company organized, sponsored, operated or controlled by such depository institution securities affiliate, or which receives investment advice from such depository institution securities affiliate. The Commission may, by rules and regulations or order, permit such loans which the Commission deems to be in the public interest and consistent with the protection of investors, and the terms of which the Commission determines to be fair and reasonable and not to involve overreaching on the part of any person concerned."

L. BANKING POWERS FOR SECURITIES FIRMS, SECURITIES POWERS FOR BANKS, AND REPEAL OF INTERSTATE BANKING RESTRICTIONS

Amendments to the Bank Holding Company Act

[Additions to the Administration Proposal are Underlined; Deletions from the Administration Proposal are in Brackets]

Sec. 11. Subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)), is hereby amended by deleting the penultimate sentence thereof and by adding a new paragraph (15) as follows: "(15) shares of any depository institution securities affiliate engaged in activities in accordance with the limitations contained in this paragraph:

* * *

"(iii) In addition to the activities referred to in subparagraphs (i) and (ii) of this paragraph, such depository institution securities affiliate may --

* * *

"(E) sell, distribute, and underwrite stocks, bonds, debentures, notes and other securities.

* * *

Sec. 42. Section 3 of the Bank Holding Company Act, as amended (12 U.S.C. 1842), is amended by deleting subsection (d), known as the Douglas Amendment, in its entirety.

Amendments to the McFadden Act

Section 43. The McFadden Act, as amended (12 U.S.C. 36), is amended by repealing it in its entirety.

M. TRUST POWERS FOR THE MEMBERS OF THE MUTUAL FUND INDUSTRY

Amendments to the Investment Advisers Act of 1940 and Related Acts

Sec. 44. (a) The Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-1 et seq.) is hereby amended by adding a new section 80b-3A following section 80b-3:

"Notwithstanding paragraph 'Seventh' of Section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), Sections 20, 21, or 32 of the Banking Act of 1933 (12 U.S.C. 377, 378 or 78) the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.), or the Saavings and Loan Holding Company Act Amendments of 1967 (12 U.S.C. 1730a), an investment adviser registered pursuant to 15 U.S.C. 80b-3 which on July 1, 1983, organized, sponsored, operated or rendered investment advice to an open-end investment company, or such adviser's parent, affiliate, or subsidiary, upon filing a certificate of election with the Comptroller of the Currency, may exercise all the trust powers of a national banking association as specified in 12 U.S.C. §92a(a); provided, however, that such adviser, or such adviser's parent, affiliate or subsidiary shall not be deemed a 'national banking association' for the purposes of the McFadden Act (12 U.S.C. 36) nor be deemed a 'bank' or 'bank holding company or subsidiary thereof' for the purposes of the Douglas Amendment to the Bank Holding Company Act (12 U.S.C. 1842(d))."

(b) Paragraph "Seventh" of Section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), is hereby amended by adding the words: "Except as provided in section 80b-3A of the Investment Advisers Act," before the words: "the business of dealing in securities and stock."

(c) Section 32 of the Banking Act of 1933 (12 U.S.C. 78), is hereby amended by adding the words: "Except as provided in section 80b-3A of the Investment Advisers Act," at the beginning of such section.

(d) Section 20 of the Banking Act of 1933 (12 U.S.C. 377), is hereby amended by adding the words: "except as provided in section 80b-3A of the Investment Advisers Act," before the words: "no member bank shall be affiliated in any manner."

(e) Section 21 of the Banking Act of 1933 (12 U.S.C. 278), is hereby amended by adding the words: "except as provided in section 80b-3A of the Investment Advisers Act," before the words: "to engage at the same time to any extent whatever."

N. STRENGTHENED PROHIBITIONS AGAINST BANK SUPPORT OF SECURITIES AFFILIATES

Amendments to the Federal Reserve Act

[Additions to the Administration Proposal are Underlined; Deletions from the Administration Proposal are in Brackets]

Sec. 15. (a) The Federal Reserve Act is amended by adding new Section 23B immediately following Section 23A (12 U.S.C. 371c) thereof to read as follows:

"Sec. 23B. RESTRICTIONS ON TRANSACTIONS WITH AFFILIATES. -- (a) A [member bank] depository institution and its subsidiaries may not engage in any of the following transactions, unless the Board first has determined that the [only on] terms and [under] circumstances, including credit standards, of the transaction [that] are substantially the same as, or at least as favorable to, such [bank] depository institution or its subsidiary as those prevailing at the time for comparable transactions with or involving other non-affiliated companies or, in the absence of comparable transactions, those terms and circumstances that in good faith would be offered to, or would apply to non-affiliated companies, so that no unfair benefit, whether such benefit may be in the form of financial, business, or any other support, inures to an affiliate by virtue of its association with the depository institution and its subsidiaries:

"(1) any covered transaction, as defined in section 23A, with an affiliate;

"(2) the purchase or sale of securities or other assets, including assets subject to an agreement to repurchase, to or from an affiliate;

"(3) the payment of money or the furnishing of services to an affiliate, under contract, a lease, or otherwise;

"(4) any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the [bank] depository institution or any other person; or

"(5) any transaction or series of transactions with a third party, (A) if an affiliate has a financial interest in the third party, or (B) if an affiliate is a participant in such transaction or series of transactions.

For the purposes of this subsection, any transaction by a [member bank] depository institution with any person shall be deemed to be a transaction with an affiliate of such [bank] depository institution to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, such affiliate.

"(b) A [member bank] depository institution and the affiliates of such [bank] depository institution shall not publish any advertisment or enter into any agreement stating or suggesting that the [bank] depository institution shall in any way be responsible for the obligations of its affiliates[; however, a member bank and its affiliates may use similar names].

"(c) A [member bank] depository institution and any subsidiary of such [bank] depository institution --

"(1) shall not purchase as fiduciary any securities or other assets from any affiliate unless such purchases are required [permitted under the instrument creating the fiduciary relationship,] by court order[, or by law of the jurisdiction under which the trust is administered]; and

"(2) [whether] acting as principal [or fiduciary], shall not knowingly or otherwise acquire, during the existence of any underwriting or selling syndicate, any security a principal underwriter of which is an affiliate of such [bank] depository institution; except that this prohibition shall not apply where the Board in advance has approved the purchase of such securities as consistent with the public interest and as not involving overreaching on the part of any person.[has been approved, prior to the time at which such securities are initially offered for sale to the public, by a majority of the directors of the bank who are not officers or employees of the bank or any affiliate thereof.]

For the purpose of this paragraph, the term 'security' means a 'security' as defined in section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)[(12)](10)); and the term 'principal underwriter' means any underwriter who, in connection with a primary distribution of securities, (A) is in privity of contract with the issuer or an affiliated person of the issuer; (B) acting alone or in concert with one or more persons, initiates or directs the formation of an underwriting syndicate; or (C) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

"(d) For the purpose of the section --

"(1) the term 'affiliate' means an 'affiliate' as defined in Section 23A of the Federal Reserve Act (12 U.S.C. 371c) excluding a bank; and

"(2) the terms ['bank,] 'subsidiary', 'person', and 'security' (other than security as used in subsection (c)) have the same meanings given to them in Section 23A of the Federal Reserve Act (12 U.S.C. 371c)."

"(3) the term 'depository institution' has the meaning ascribed to it by Section 1814(k)(2) of this Title (12 U.S.C. 1841(k)(2)) and Section 1730a(a)(1)(K)(ii) of this Title (12 U.S.C. 1730a(a)(1)(K)(ii)), and includes an uninsured institution as that term is defined in Section 1730a(a)(1)(B) of this Title (12 U.S.C. 1730a(a)(1)(B))."

"(e)[The Board may prescribe rules and regulations to administer and carry out the purposes of this section, including rules or regulations to (1) further define terms used in this section; (2) exempt transactions or relationships from the requirements of this section; or (3) exclude from the definition of 'affiliate' in this section any subsidiary of a bank holding company, if the Board finds such exemptions or exclusions to be in the public interest and consistent with the purpose of this section.] Nothing in this title shall be deemed to authorize the Board to exempt any person, transaction or relationship from the requirements of the federal securities laws, as that term is defined in Section 21(g) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78u(g)). Furthermore, nothing in this title shall be deemed to alter, affect, amend, invalidate, or repeal any provision of the Investment Company Act of 1940.

* * *

O. EXPRESS GLASS-STEAGALL ACT PRIVATE RIGHT OF ACTION

Amendments to the Banking Act of 1933

Sec. 45. Section 21 of the Banking Act of 1933, as amended (12 U.S.C. §378), is hereby amended to add the following new subparagraph (c):

(c)(1) Any person injured by reason of any conduct forbidden in sections 24 (Seventh), 78, 377, and 378 of this title may bring suit in any United States district court where the defendant resides, or is found, or transacts business, or has an agent, to recover the damages sustained by him, or to obtain injunctive or other equitable relief.

(c)(2) Any action to enforce any cause of action under subsection (c)(1) shall be forever barred unless commenced within six years after the cause of action accrued.

(c)(3) Any action for injunctive or other equitable relief that may be commenced by any person pursuant to subsection (c)(1) may be commenced on behalf of such person by any trade association of which such person is a member, provided that any such action commenced by a trade association shall be subject to the same requirements, limitations, and conditions as would be applicable had such action been commenced by any person pursuant to subsection (c)(1).

P. EXPEDITED CONVERSION PROCEDURES

Amendments to the Securities Act of 1933

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 4. Section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77d), is hereby amended by adding [a] new paragraphs (7) and (8) at the end thereof:

"(7) transactions involving offers or sales of equity securities, in connection with the acquisition of a bank by a company under the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 *et seq.*), or in connection with the acquisition of an insured institution by a company under the Savings and Loan Holding Company Amendments of 1967, as amended (12 U.S.C. 1730a), if such acquisition occurs solely as part of a reorganization in which a person or group of persons exchange their shares of a bank or insured institution for shares of a newly formed bank holding company or savings and loan holding company and receive, after such reorganization, substantially the same proportional share interest in the holding company as they held in the bank or insured institution, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under state law.

"(8) transactions involving offers or sales of equity securities, undertaken in order to form a company to acquire a bank under the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.), or in order to form a company to acquire an insured institution under the Savings and Loan Holding Company Act Amendments of 1967, as amended (12 U.S.C. 1730a), if the formation of such company occurs solely as a reorganization in which a person or group of persons exchange their shares of an existing company for shares of the newly formed company and receive, after such reorganization, substantially the same proportional share interest in the newly formed company as they held in the existing company, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under state law.

Amendments to the Bank Holding Company Act

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 8. Subsection 3(a) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1842(a)), is hereby amended by adding the following immediately preceding the period at the end of the second sentence of such subsection:

";[or] (C) with 30 days prior notification to the Board, the acquisition by a company of control of a bank in a reorganization in which a person or group of persons exchange their shares of the bank for shares of a newly formed bank holding company and receive, after such reorganization substantially the same proportional share interest in the holding company as they held in the bank except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under state law, provided that, immediately following such acquisition, the bank holding company meets the capital and other financial standards prescribed by the Board by regulation for such a bank holding company and the holding company does not engage in any activities other than those of banking or managing and controlling banks. In promulgating regulations pursuant to this subsection, the Board shall not require more capital for the subsidiary bank immediately following the reorganization than is required for a similarly sized bank that is not a subsidiary of a bank holding company [.".]"; or, with 30 days prior notification to the Board, the formation of a company to acquire control of a bank in a reorganization in which a person or group of persons exchange their shares in an existing company for shares of a newly formed company and receive, after such reorganization, substantially the same proportional share interest in the newly formed company as they held in the existing company except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under state law, provided that, immediately following the acquisition of a bank by the newly formed company, the resulting bank holding company meets the capital and other financial standards prescribed by the Board by regulation for such a bank holding company and the holding company does not engage in any activities other than those of banking or managing or controlling banks. In promulgating regulations pursuant to this subsection, the Board shall not require more capital for the subsidiary bank immediately following its acquisition than is required for a similarly sized bank that is not a subsidiary of a bank holding company.".

Amendments to the Savings and Loan Holding Company Act Amendments of 1967

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 21. Subsection (e) of the Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a(e)) is hereby amended by amending clause (ii) of subparagraph (1)(B) to read as follows, and by adding the following clause (iii):

"(ii) acquired in connection with a reorganization in which a person or group of persons exchange their shares of an insured institution for shares of a newly formed holding company and receive, after such reorganization, substantially the same proportional share interest in the holding company as they held in the insured institution, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under state law[.] , or (iii) acquired subsequent to a reorganization in which a person or group of persons exchanged their shares of an existing company for shares of a newly formed company and received, after such reorganization, substantially the same proportional share interest in the newly formed company as they held in the existing company, except for changes in shareholder interest resulting from the exercise of dissenting shareholder rights under state law.".

Q. IMPROVED GRANDFATHER RIGHTS FOR COMPANIES OWNING NON-BANK BANKS AND SINGLE THRIFTS

Amendments to the Bank Holding Company Act

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 9. Section 4(a)(2) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(a)(2), is hereby amended to read as follows --

* * *

"Provided further, (I) That the two-year period referred to in this paragraph shall not apply to a company that becomes a bank holding company as a result of enactment of the Financial Institutions Deregulation Act and that acquired a bank between July 1, 1983, and the effective date of such Act; and (II) That a company that becomes a bank holding company as a result of the enactment of the Financial Institutions Deregulation Act, and that controlled an insured bank on July 1, 1983, may engage in any activity in which it was lawfuly engaged, directly or through a subsidiary, on July 1, 1983, and in which it has been engaged continuously since July 1, 1983, provided that any activities authorized for bank holding companies may not be expanded and any additional activities may not be commenced except in accordance with the requirements, conditions and limitations applicable to bank holding companies. The authority conferred by the preceding clause (II): (a) shall terminate at such time as (1) any covered bank holding company acquires control of an additional bank or an insured institution, or (2) its existing subsidiary bank commences accepting deposits that the depositor has a legal right to withdraw on demand and engages in the business of making commercial loans[, or (3) any covered bank holding company commences, directly or through a subsidiary, after July 1, 1983, any additional activities, other than those activities authorized pursuant to this Act (except for the acquisition of an insured institution), in which it was not engaged on July 1, 1983]; and (b) may be terminated by the Board by order, after opportunity for hearing, if it determines, having due regard to the purposes of this chapter, that such action is necessary to prevent conflicts of interest or unsound banking practices or is in the public interest[.".]; Provided, however, That the Board may, upon application by any such covered bank holding company, extend the authority conferred by this subsection for an appropriate period of time in the public interest, but in no event shall such period of time exceed one year.".

Amendments to the Savings and Loan Holding Company Act Amendments of 1967

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Section 19. Subsection (c) of the Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a(c)) is hereby amended to read as follows:

"(c)(1) Except as otherwise provided in this subsection, no savings and loan holding company (except a unitary savings and loan holding company that acquires an insured institution pursuant to subsection (m) of this section) or subsidiary thereof which is not an insured institution shall --

* * *

"(B) commence or continue, after two years from the date as of which it becomes a savings and loan holding company, any business activity other than those specified in paragraph (2) of this subsection except that such two period shall not apply to any company that acquires an insured institution between July 1, 1983, and the effective date of the Financial Institutions Deregulation Act. Provided, That any company that becomes subject, as a result of the Financial Institutions Deregulation Act, to the prohibitions of this subparagraph and that controlled an insured institution prior to July 1, 1983, may engage in any activity in which it was lawfully engaged, directly or through a subsidiary, on July 1, 1983, and in which it has been engaged continuously since July 1, 1983, provided that any activities authorized for savings and loan holding companies may not be expanded and any additional activities may not be commenced except in accordance with the requirements, conditions and limitations applicable to savings and loan holding companies. The authority conferred by the preceding proviso, (A) shall terminate at such time as any covered savings and loan holding company (i) acquires a bank, or its subsidiary insured institution fails to qualify as a domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code of 1954[, or (ii) commences, directly or through a subsidiary, after July 1, 1983, any additional activities, other than those authorized pursuant to this Act to be permissible for savings and loan holding companies (except for the acquisition of a bank), in which it was not engaged on July 1, 1983,] or (B) may be terminated by the Corporation, after opportunity for hearing, if it determines, having due regard to prevent conflicts of interests, unsound practices, or in the public interest[.]; Provided, however, that the Board may, upon application by any such covered savings and loan holding company, extend the authority conferred by this subsection for an appropriate period of time in the public interest, but in no event shall such period of time exceed one year.

R. DUE PROCESS PROTECTIONS FOR MEMBERS OF THE SECURITIES INDUSTRY

Amendments to the Bank Holding Company Act

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 10. Paragraph 8 of subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)(8)), is hereby amended to read as follows:

* * *

"(v) The Board shall by order set forth the reasons for any disapproval under this paragraph. Inaction on any notice or a Board order determining not to disapprove a proposal [to engage in an activity that has previously been authorized by regulation under this paragraph shall be final and shall not be subject to judicial review under this Act or in any other manner; provided, however, that] is reviewable pursuant to Section 9 of this Act upon petition by any interested person (or a trade association acting on behalf of such a person), and any bank holding company may obtain judicial review pursuant to section 9 of this Act of any Board order not to disapprove a notice under this paragraph if such order contains restrictions or conditions.

"(vi) The Board shall, within one hundred and eighty days of enactment of the Financial Institutions Deregulation Act and from time to time thereafter, promulgate regulations under this paragraph designating particular activities that are closely related to banking or of a financial nature. A bank holding company may petition the Board to determine by regulation that a particular activity is closely related to banking or of a financial nature[.], and any interested person (or a trade association acting on behalf of such a person) may oppose such petition. The Board may by regulation prescribe limitations on the conduct of any activity or activities authorized under paragraphs (8), (15) and (16) of this subsection consistent with the criteria in subparagraph (B)(iv) hereof and with safe and sound financial practices. In administering this paragraph, the Board shall promote competition between bank holding companies and all other companies engaged in activities of a financial nature or closely related to banking.

* * *

Amendments to the Savings and Loan Holding Company Act Amendments of 1967

[Additions to the Administration's Proposal are Underlined; Deletions from the Administration's Proposal are in Brackets.]

Sec. 19. Subsection (c) of the Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a(c)) is hereby amended to read as follows:

* * *

> "(E) The Corporation shall by order set forth the reasons for any disapproval under this paragraph. Inaction on any notice or a Corporation order determining not to disapprove a proposal [to engage in an activity that has previously been authorized by regulation under this paragraph shall be final and shall not be subject to judicial review under this Section or in any other manner, provided, however, that] is reviewable pursuant to this Section on petition by any interested person (or a trade association acting on behalf of such a person), and any savings and loan holding company may obtain judicial review pursuant to this Section of any Corporation order not to disapprove a notice under this paragraph if such other contains rerestrictions or conditions.

* * *

The **CHAIRMAN**. Thank you, Mr. Silver.

Mr. Jenrette, in your opening comments about you wish that the industries could get together and just thrash it out, that is what these hearings and these bills are all about, an attempt to do that because it makes no difference which segment of the industry is testifying, they are pure and clean and the others are wrong. And you have followed the hearings, I'm sure, and each segment protects their own turf, and they should. If you don't defend yourself, no one else will, and I understand that.

FINANCIAL INDUSTRY IS GETTING VERY COMPLEX

But on the other hand, it isn't all black and it isn't all white and all the comments about the banks—I understand where you're coming from. But on the other hand, other than the mention of money market mutual funds and what was done there, there is no mention in your testimony of the nonbank bank issue and all the incursions of the securities industry into at least banking-like activities, if I could put it that way.

And each of the people who have testified, regardless of which area they are talking about, tend to ignore what they are doing. The fact of the matter as I see it is that everybody is trying to get into everybody's business, at least to a certain extent, claiming that that's all right for them but everybody else should be prohibited.

That's why I agree with you that we need to try and rationalize that, and that is the purpose of these hearings; not for Congress to come up with a prescribed blueprint and say this is what we are imposing on everybody, but to have a give and a take and a dialog and see if some consensus cannot be worked out, because I think it is for the good of everyone. Everyone is part of the problem. Everyone will need to be part of the solution or we will continue with more attempts to find loopholes, to find ways to better serve customers; we will certainly see a great deal more State action.

And so whatever the end result of these deliberations are and however provisions are changed in S. 2181 or what kind of a bill we eventually come up with, I think it's important that we make those decisions. If the decision of the Congress is that banks should not enter into these fields, so be it. If the decision is that they change the definition so that prohibits the nonbank banks, so be it.

As I've said many, many times, I have no great pride of authorship. My major concern is that we not allow the current situation and the dramatic changes in the marketplace just to go on with the blowing of the winds.

So my first question would simply be, do either one of you on a general premise—and I've asked every group who's come before me this question and I think it's the most important question at this time, rather than the differences of opinion on specifics which I fully understand—do you think that it is important to come to some decisions, for Congress to act and try and rationalize what is going on out there?

Mr. **JENRETTE**. Mr. Chairman, I certainly agree with you on that. I didn't want to appear holier than thou in any way and I'm not countenancing the fact that some members of my industry have been moving into this nonbank bank area. It doesn't really reflect the opinion of the majority of our industry. I mention that it was more a competitive response to what now seemed like an unfair advantage enjoyed by banks with their money market funds that was causing some of the major brokerage firms to feel they had to have banks. So it's really a vicious cycle. But we certainly agree, no one is simon pure. No one is holding themselves up as an industry to be totally pure.

The CHAIRMAN. Mr. Silver.

Mr. SILVER. Mr. Chairman, I guess you do have three choices. One, you can decide that the present situation is tolerable; two, you can try to restore the Glass-Steagall Act to pristine purity and move in that direction, and I think that there are strong public policy considerations that may tug you that way. The other possibility, of course, is to tear down the barriers. But I think, as I've suggested, that tearing down those barriers will involve public policy decisions to in effect abandon the unique advantage that banks enjoy as banks so that free entry into banking is permitted by competitors. And I may say I would join in the comment that my segment of the securities industry shares in the creativity or fault, whichever way you look at this, but I would have to add, Senator——

The CHAIRMAN. I call it creativity.

Mr. SILVER. Well, I've read the transcripts and I think your admiration of lawyers seems to be unbounded.

The CHAIRMAN. I'm just proud that I'm not one.

Mr. SILVER. But with all due respect, I really don't think lawyers have gotten any smarter over the past 2 years than they were for 48 years. At least I hope they haven't. For 48 years, the Glass-Steagall Act endured fairly well. It's only in the last 2 or 3 years that there have been dramatic developments on the regulatory front. The regulators are supposed to be the cops on the beat but for each business initiative there has been a corresponding regulatory lapse, in my view, which permitted this to happen.

I cannot believe that for 48 years nobody thought that State banks could get into the securities industry through the Glass-Steagall barrier and only some smart lawyer dreamt that up 2 years ago; or that for 48 years common trust funds were not thought to be mutual funds until the Comptroller of the Currency last year decided that they were.

So, yes, you have nonbank banks and all the rest, but I don't think you have the cops on the beat. I think you may have noncop cops, and that may be part of the problem here. [Laughter.]

The CHAIRMAN. Let me pin you down a little bit more generally because you've gotten more specific on me about the options of tearing down Glass-Steagall or doing nothing and so on. Glass-Steagall is not going to be torn down, not in the terms some people would like to think we're talking about—there's going to be a wholesale changing of Glass-Steagall into general commerce and all that. That's not being proposed. That's not going to happen.

So let me get back to the question Mr. Jenrette offered. Between the choices of doing nothing and doing something without knowing exactly what that would be but you know it's going to be, if anything, someplace in between, just like it was if you look at S. 1720. There were a lot of changes which you and others were involved in the discussions on through that whole process. The difference between S. 1720 and Garn-St Germain are considerable and the differences between S. 2181 and S. 2134 will change dramatically before any legislation comes.

Is it important to try and do that or just let things go?

Mr. JENRETTE. I don't think you can just let things go because, as you said, today's lawyers seem to have found what they think are loopholes, although the Supreme Court, as you know, Mr. Chairman, is reviewing the Bank of America Schwab acquisition and also the sale of commercial paper by banks.

BARRIERS HAVE BEEN BRIDGED

The barriers have been bridged and we're not saying do nothing. But we are saying that if we grant nonbank bank consumer bank charters on the one hand as a concession to some of the brokers and open the revenue bond business to the banks—I guess what I'm saying is it's not the end of Glass-Steagall, but it's just one more major step down the road toward ending it.

And we're saying that basically these things may not seem very risky now because we're in a prosperous period. The markets have done extremely well and the conflicts maybe don't seem that great, but in a different environment it could be different, and we felt that basically the separation of banks that take deposits and make short-term loans and a different set of people providing underwriting of long-term capital works very well. Basically, our first choice would be to close the loopholes in Glass-Steagall and keep that separation of functions which has stood the test of time. Maybe it is not perfect but it really seems to work pretty well, a lot better than Germany where you've got Deustchbunde and others who are in everything.

Mr. SILVER. I guess, Mr. Chairman, it was in May 1981 when you put the question to me about money market funds and you gave me a very difficult choice. From my point of view, you were saying: Would you rather be shot or hung? You said—and I'm paraphrasing—would you rather see banks in the mutual fund business and have money market funds, or should regulation Q be repealed? And I gulped and I said, "Well, I think the public interest direction to take would be to repeal regulation Q." In other words, I opted to be shot.

And you did and we were. We lost about 30 percent of our assets. But I really didn't think that 3 years later I would be back now ready to be hung. I would still give the same answer, which is implicit, that I would personally go in the direction of preserving the separation because I think going down the other road, as I tried to say in my testimony, is really going to require ultimately too many dramatic changes in both industries to reach a fair competitive balance.

The CHAIRMAN. I understand what your individual preference is very well, both publicly and privately you and I have had a lot of discussion over the years. The more pleasant ones are about photography, flying, and some other things.

I'm not asking you a choice. That was a much more specific question and that's why I specifically said, however it comes out, do you think we should and achieve that this year rather than just letting it go? Maybe it comes out your way. Maybe it comes out that banks are flat squeezed out and they're not going to get any of these. I would suspect it would be more some kind of a compromise. I don't know. We're not even through with the hearing process.

But my point again is simply do you think it is worthwhile to pursue this process and attempt to come to some decisions this year without asking you do you prefer this or that. That's not my question. It's a much more general question.

Mr. SILVER. Yes; I think the process should be pursued, but I would warn you in the most friendly sense that at the end of that road——

The CHAIRMAN. If you don't like it, you're against it?

Mr. SILVER. You may be convinced that the price that you're going to pay from a policy point of view is too high to pursue that road and things should be left as they are.

The CHAIRMAN. Exactly. That may be the outcome. That's why I wasn't giving you a choice between being hung and being shot, but we could simply say, well, we'll make that determination now without the benefit of hearings, without the benefit of trying to get people together and make a determination. That may be the outcome. It could very well be no bill whatsoever.

But almost without exception, without prejudice to their own individual positions, everybody feels that the marketplace is in such a state that we ought to try—we ought to continue the process with all of those participating and expressing their viewpoints, and see if it's possible to come up with something.

Senator Proxmire is next. Senator Heinz has requested to go first.

Senator PROXMIRE. Fine.

Senator HEINZ. Senator Proxmire, if I could, I have a Finance Committee hearing and I'll try to be brief and I thank Senators Hecht and Garn as well for their deferring to me.

The CHAIRMAN. Senator Sarbanes wants to know what you're going to do at Finance before he agrees to this. [Laughter.]

Senator HEINZ. Tell Senator Sarbanes that if I had any idea what we're going to do in Finance I'd be a rich man. As it is, I think we're all going to end up poorer.

Senator PROXMIRE. If the Senator from Pennsylvania would yield, he is a rich man, let me tell you.

Senator HEINZ. We all took a vow of poverty when we became Senators. Senator Garn is the expert on that, by the way.

The CHAIRMAN. That's true. Nobody forced me to have seven children.

Senator HEINZ. That's not what Kathleen said. [Laughter.]

Thank you for yielding to me, Mr. Chairman.

One issue, of course, that we are confronting is the extent to which Congress is going to sit back and allow regulators or those in various industries—banking and nonbanking financial industries—to deregulate the financial services industry without Congress speaking on the issue.

Now I think it would be irresponsible for Congress not to express a judgment on it this year. We ducked it last year because we sought, I think correctly, to see what other possibilities existed. I think the purpose of these hearings is to see what other possibilities exist.

CONGRESS MUST CLOSE LOOPHOLES IN 1984

But it is my own personal view that the Congress is not going to adjourn sine die this year without closing both the so-called nonbank banks and South Dakota loopholes.

I can't imagine that we would play that kind of roulette with all the people involved and with the public.

Now as a result, we are going to have to deal with the issue of grandfathering. Now it's my personal view that it is equally inconceivable that Congress is going to look benignly on the continued rush—and there is a line that goes round the block down at the Comptroller and the Fed—that we are going to allow any of the people who go through those doors of the Comptroller or the Fed to remain in the building at this late date.

Now there may be broad disagreement on this issue in this room or among the members of the committee. I'm expressing a personal view, but I think it's frankly highly unlikely that if there are some additional significant entries from the nonbanking area into banking or vice versa that are permitted by our regulators or by the States, in the case of the South Dakota loophole situation, it seems highly unlikely to me that Congress will bless such regulatory abdication.

Now, Mr. Jenrette, you have said, as I understand it, that you endorse loophole closing legislation. Yet one of your members is E. F. Hutton, and they have crossed the threshold from nonbanking into banking. How would you suggest we treat the problem of grandfathering? Do you think we should tell E. F. Hutton to get out of their nonbank banking?

Mr. JENRETTE. I listen when E. F. Hutton talks, but in this case I don't agree with them. I don't think the grandfathering would be at all fair.

Senator HEINZ. Mr. Chairman, we've got some good one-liners here—noncop cops, listening when E. F. Hutton talks——

Mr. JENRETTE. Those of us who exercise restraint and have not been rushing into forming bank subsidiaries would be penalized if those who accelerated the charge are rewarded. I think it would be grossly unfair to the rest of us who have exercised restraint while this process of decisionmaking has been going on.

Senator HEINZ. So the position of the SIA is although E. F. Hutton has talked, we don't agree with them?

Mr. JENRETTE. Well, I guess we haven't specifically in the SIA board taken a vote on that. Maybe they'll outvote me. I don't believe that that would happen, so I guess I'll have to be personal.

Senator HEINZ. Your tentative trial position as current president, subject to change in one respect or another.

I have a somewhat different question. This will be my last question, Mr. Chairman.

Mr. Silver, you mentioned the significant amount of equities held by bank trust departments, principally by virtue of their pension fund management responsibilities, some 44 percent I think you mentioned of all the equities in the United States are in such bank-run pension funds, a much larger amount than the amount of equities in mutual funds.

Now I guess my question is this. We are concerned, as Senator Garn has said, we are concerned about not breaking Glass-Steagall apart and letting banks into commerce generally and so forth, and I think he's quite correct in stating that. At some point when banks acquire a certain kind of fiduciary responsibility for equities, like obviously ownership of equities is clearly across the line—but at some point between ownership and being a pension fund management trustee, there may be a position where we really cross that Glass-Steagall line. And I'm not talking about tie-ins and conflict of interest and the kinds of things you might be able to handle through a separate sub.

I'm talking about how close to the Glass-Steagall line are we getting when banks manage mutual funds and so let me try and see if I can phrase a question that makes sense.

Is there a control difference? Are there differences in terms of the heightened influence a bank would have over the equities in a mutual fund as opposed to their responsibilities over pension funds?

Mr. SILVER. Well, I think in the first instance it's a question of degree, but questions of degree can then become questions of kind, and I think you'll have several different considerations.

First, I would agree with the inference in the question that at some point control does equal ownership. Second, I would say one of the questions you would have to wrestle with is do you want diversity in institutional holdings or do you want institutional holdings essentially concentrated in a few large banks.

BANKS WILL DOMINATE WHEN THEY ENTER

You would certainly—and I think Mr. Jenrette's answer to a previous question indicated the same belief that I share—that if banks will come into this business they will dominate this business. It happened in the 1920's and there's no reason why they shouldn't dominate investment management again if they were permitted in it now.

Senator HEINZ. Does a bank have more control or influence over the management of a corporation whose pension fund assets they manage or over a corporation whose securities they hold by virtue of their ownership of the mutual fund?

Mr. SILVER. I think it would be precisely the same in the case of the bank. There's no evil intent here. There is just a question that you're going to manage your banking business in tandem with your trust department and you're going to manage your trust department in tandem with what you're doing on the commercial side of the bank, and the stronger that interest becomes, the more intense the conflict becomes.

Also, when you concentrate institutional holdings, which this development I think would do, you're diluting and subtracting from the diversity which has been characteristic of this country.

Now some years ago I was a consultant to the Indian Government on securities regulation and they were wondering why their secondary markets didn't function well. Well, it turned out that they had made the decision to nationalize the 200 life insurance companies in the country and you have 1 gigantic life insurance company with 1 gigantic portfolio, and then they were wondering why the secondary trading markets didn't work very well.

Well, the secondary trading markets work very well because some investors see opportunities to buy where others want to sell.

This idea of going forward along this line without examining this issue, which really hasn't been examined at all—I agree with what Senator Garn has often said, that in one sense these issues have been studied to death, but certainly the whole question of institutional holdings of securities and the implications which would flow from further concentration in banks hasn't been studied by anybody.

It was with the greatest difficulty that we managed to secure any data whatsoever on bank equity holdings that we presented in our testimony. They are not routinely published by anyone. No agency has studied this since the SEC about 15 or 20 years ago.

Senator HEINZ. Mr. Chairman, thank you very much. I thank the members. My time has expired.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Jenrette and Mr. Silver, I want to congratulate both of you on excellent, clear statements, and I think they're among the best we've heard and we've heard some very fine statements in these hearings.

When Mr. Silver said in response to a question from the chairman that it might be better to leave things as they are, I don't think we have that option. They wouldn't stay as they are.

If we leave things as they are, we lose complete opportunity to determine our financial policy. They will be taken out from under us. They will be decided by regulators, by State legislatures, by a conglomeration of people who can't look at this, it seems to me, from a national standpoint. I think we have an absolute duty to act. I don't think we have much alternative.

Now, Mr. Jenrette, my bill, S. 2134, includes a provision for State-chartered banks not belonging to the Federal Reserve System to be brought under the Glass-Steagall Act.

How essential is it that Congress act to close this loophole in Glass-Steagall?

Mr. JENRETTE. Well, I don't think we want to get competition between States for liberality in allowing underwriting. I think we should close it.

Senator PROXMIRE. Do you support legislation requiring firms to divest themselves of the nonbank banks they recently acquired?

Mr. JENRETTE. Yes. It seems to me that if we are going to preserve the Glass-Steagall we can't keep going down this road, and if the decision is made to keep the two industries separate, then those who have leapfrogged ahead shouldn't be given a competitive advantage by allowing them to keep it.

Senator PROXMIRE. Mr. Silver, like the others I've heard you testify here and I was very impressed by your capacity to coin a phrase. I was delighted to hear you characterize the noncop cops.

The Bush Commission proposes to give the most notorious noncop cop the real authority in regulating the banks and that bothers me considerably.

I understand that 70 percent of equity mutual funds are still sold on a load basis with an upfront load of up to 7 percent.

If banks were permitted to offer mutual funds, wouldn't there be more competition leading to more no-load funds, thus benefiting investors?

Mr. **Silver**. Well, Senator, I can answer that I think. Five years ago there were 500 mutual fund members of the Investment Company Institute. Today there are 1,000 members. We'll probably break 1,000 this week. There is increasing competition within the industry and the no-load sector—and this we do have the statistics on—has grown very substantially in the last 20 years and it's a pattern of growth which has not been disturbed. There is competition in the industry.

Senator **Proxmire**. Well, they're growing but, as I said, 70 percent of the mutual funds are still sold on a load basis. So if banks were permitted to get into this, there's an assumption there would be more no-load funds to the benefit of the consumers. They're 30 percent, it's true, and it's been expanding, but why not let the banks get into this?

Mr. **Silver**. There's no reason to think the banks would have any more no-load funds than anyone else. In 1970 I recall, when we discussed the mutual fund legislation that was enacted back then, the argument was that if banks were in the mutual fund business advisory fees would be lower. Well, now banks have crept into the tent to a certain extent and we find that their advisory fees are precisely the same as everybody else.

Senator **Proxmire**. Well, suppose we require banks get into this on a no-load basis.

Mr. **Silver**. I would see no more reason for doing that than to say banks would have to sell no-load life insurance. If you're going to go the competitive route, Senator, we are prepared to go that competitive route, but we want access to banking; we want to be able to bring our strengths to bear in the banking industry. That's the problem you're going to face here, not the problem of mutual fund sales charges. The marketplace has functioned very well.

Senator **Proxmire**. Mr. Jenrette, what would be your attitude regarding the need for legislation to include some modification of the so-called sledgehammer rule on broker deposits?

GARN-ST GERMAIN ACT EQUALED THE PLAYING FIELD

Mr. **Jenrette**. The debate over brokered deposits is keyed back to the debate over the nonbank bank. When the Garn-St Germain Act equaled the playing field—there's that term again—the banks, of course, got $380 billion in new money market funds and this confronted the securities firms that were major factors in money market funds with the frantic situation that they were potentially going to lose it all to the banks. By owning their own nonbank bank or brokering deposits they could, in effect, still be selling FDIC guaranteed certificates of deposits to their customers. We feel that the public wants FDIC guaranteed deposits as a haven for short-term funds. Anything that breaks that up essentially weakens the competitive position of securities firms vis-a-vis the banks.

Senator PROXMIRE. Let me ask you, Mr. Jenrette, why should securities firms, be able to retain a monopoly over revenue bond underwriting when there's no record of bank abuses involving general obligation bond underwriting and when the history of Glass-Steagall indicates that it's very likely that if revenue bonds had been a consideration at that time, Glass-Steagall might very well have permitted banks to underwrite revenue bonds like general obligation bonds?

Mr. JENRETTE. Well, first, we felt that the underwriting of longer term debt as well as equity, including general obligation bonds, should not have been given to banks in the first place.

Senator PROXMIRE. But there have been no abuses of that?

Mr. JENRETTE. No, there haven't. Well, let's come back again—I think New York City is an excellent example where the banks were banking short-term loans to New York City and they found themselves in the difficult position of virtually feeling they had to keep floating general obligations for the city of New York to pay off the short-term loans, and I think that is an excellent example of the problems of banks getting into underwriting where they have short-term loans of their depositors money outstanding and there's an overwhelming pressure to keep selling long-term debt to bail out those loans.

Senator PROXMIRE. Well, revenue bonds, it seems to me, would be even safer than general obligation bonds, by and large, particularly in view of the fact that it's tied to a specific source of revenue and the bonds can be sheltered and protected in such a way that the risk is easily calculable.

Mr. JENRETTE. Some are and some aren't.

Senator PROXMIRE. What I keep thinking of is the situation where you have a small community and there's a bank in the community, but it's rare that you have investment people there, and the bank in serving as an underwriter obviously would have to work with a correspondent to get the capital needed if it were a big operation, but nevertheless, has such a big advantage being in the community, being part of the community, recognizing the problem so much better than an outsider might be able to do.

Mr. JENRETTE. Well, of course, our members are everywhere, too. I mean, there's hardly a place you won't find a Merrill Lynch office and, in our case, with our correspondent network, we have several regional firms.

Senator PROXMIRE. There are an awful lot of little towns in Wisconsin that don't have a Merrill Lynch office or any other brokerage office. They all have banks.

Mr. JENRETTE. It's unlikely that if it's that small that the bank is going to be qualified.

Senator PROXMIRE. That's why I say they would have to work through correspondents, but nevertheless, they would have local expertise and the local interest, and I think there would be much better feeling about it.

Mr. JENRETTE. Certainly the revenue bonds underwritten are by no means limited to large cities.

Senator PROXMIRE. What evidence is there that securities firms were less eager to underwrite New York City securities compared to banks?

Mr. **Jenrette**. There were some there. I think the issues were dominated by the large banks who were doing the bulk of it. There were some securities firms in there and I believe the answer is that they were swept along with the tide because of the banks dominance in that area. You don't just walk out if your alma mater or your bank is in there, and presumably they were the first to blow the whistle on the city. You tend to go along with it.

If there had been no banks underwriting, I honestly think the whistle would have been blown sooner on New York City.

Senator **Proxmire**. Thank you, Mr. Chairman. My time is up.

The **Chairman**. Senator Hecht.

Senator **Hecht**. Thank you, Mr. Chairman.

I have enjoyed your testimony. I've asked this question from the beginnings of the hearings and I'd like to have your thoughts on it.

WHAT NEEDS TO BE FIXED

Specifically, what is broken now that has to be fixed? Mr. Jenrette, would you like to answer that first?

Mr. **Jenrette**. Well, that's what I've been trying to figure out. I think the system really works well, although I admit that there have been some turf battles, with some firms challenging what has worked very well, the division of functions. I think rather than altering the system, or going a further step down the road toward each of us getting in each other's backyard, I'd stop now because the system has worked so well basically. There's been a lot of creativity and I guess I irritate a few of my banking friends by implying that creativity might suffer if the two industries were put together, but I would refer them to the European model where the large German banks absolutely dominate everything and they don't have that much incentive to start new companies. If you've ever tried to compete with a German bank on underwriting, you know that if they are an underwriter they can "stuff it" into these funds that they're managing and you can't compete with them because of that power they have of controlling the assets.

I don't see any reason we should go that route and I think our system of the separation of the two, the banks because of their unique Federal guarantee and Federal charter, should be precluded from some of the riskier functions such as underwriting.

Senator **Hecht**. Do you want to address that, Mr. Silver?

Mr. **Silver**. Well, I think basically I would agree with Mr. Jenrette. I would not want to really go down that alternative road of permitting free competition, letting anybody into the banking business, taking away their FDIC, and tearing down the geographical barriers. That may all come, but those are different policy decisions that would have to be made and I don't think that the conditions at this time warrant getting into those issues.

Senator **Hecht**. Mr. Silver, could you explain further why is it that you think the concentration provision of S. 2181 is not acceptable to you?

Mr. **Silver**. Well, it's not a question of it not being acceptable to me, Senator, since I don't like the whole idea. It may be consensus legislation but I have a feeling I'll end up as the consensee. But the fact is that the concentration provision simply doesn't do what it sets out to do.

Under that provision, according to one measure of Citicorp's capital, Citicorp alone could buy 80 percent of the entire mutual fund industry. Under another measure of Citicorp's capital, it could only buy 52 percent of the whole mutual fund industry. So the concentration provision is essentially meaningless. Under any measure, two banks could buy the entire mutual fund industry.

The CHAIRMAN. Would the Senator yield for a followup on that?

Senator HECHT. Sure.

The CHAIRMAN. That provision is not directed not at just banks; it is directed at financial institutions, the top largest 25, wherever they come from. This committee is concerned about concentration in any segment of the financial services industry, not just banks alone. I just wanted to make that correction. Constantly I hear that we're talking about limiting concentration in banks. That provision goes further.

I would also ask if you could submit, either one of you, for the record, rather than just saying that it's a bad provision—it was a starting place—your suggestions on how we could put in the bill effective changes you would recommend in a provision that would limit concentrations across the board, not just in banks but in securities, insurance companies, or any other industry.

Thank you, Senator Hecht.

[Information not supplied in time of publication.]

Senator HECHT. And further, to Senator Garn, I have said repeatedly, I congratulate him on having the guts to bring out such a controversial bill in an election year like this because there are these different things that have to be addressed. In these hallowed halls, sometimes we get too philosophical and we don't get down to the practical level.

There are 14,500 commercial banks in America today and there are roughly 13,000 of them that have assets of less than $100 million. Now practically, a $100 million bank is not in a position independently to buy securities. They usually use correspondents. This is out West. Is that true in the East?

Mr. SILVER. Yes; it is.

Senator HECHT. How could they underwrite securities if they're not even capable of buying them?

Mr. JENRETTE. It would be very difficult because the only way would be through a correspondent in New York. I don't know why correspondents always have to be in New York but they seem to be.

Senator HECHT. There are a lot of correspondents out West too.

Mr. JENRETTE. But I think the correspondent banking relationship would be the way they would have to go because, as you say, the expertise is not there locally, the knowledge of the marketplace, interest rates.

Senator HECHT. Well, that size bank just doesn't have the facilities or the manpower available is what I'm bringing out. How do you feel about that, Mr. Silver?

Mr. SILVER. Well, I think the answer would be the same. Only the larger banks could conceivably go into the mutual fund business.

Senator HECHT. So eventually it would filter down to just a few banks?

Mr. SILVER. Yes, sir.

Senator HECHT. No further questions, Senator.

The CHAIRMAN. Thank you, Senator Hecht.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

ONE-STOP SHOPPING CONCEPT

Today in the New York Times you may have seen Leonard Silk's column in which he raised the central questions of these issues and the movement toward one-stop shopping in financial services. He poses a rhetorical question about whether taking down the historical separations either by virtue of the regulatory process being somewhat passive and market forces taking down these separations or whether we act further in a legislative way and take them down by legislative decision. He nevertheless poses the question of whether or not it's a good thing, and I'd like to start there and ask you, Mr. Jenrette, is the one-stop shopping concept something that offers important new pluses for people? Is this something that we ought to move faster to get to or is that not the case? How would you answer the question posed?

Mr. JENRETTE. Senator Riegle, a great deal has been made of convenience of one-stop shopping for the consumer. My own view is that in many cases it has been carried to the point where it's no longer convenient.

In point of fact, you can't go to one salesperson and get advice on life insurance, automobile insurance, mutual funds, bank loans, what stocks to buy or sell. More realistically speaking, the consumer has to make 10 different phone calls within the bank or the conglomerate complex to get the necessary expertise. So there's really no time saving to the consumer.

I personally feel strongly that these things alternate both ways. I think there was a trend toward homogenizing everything, and I think the American consumer, be he the consumer of financial services or buying groceries, is sort of turning against the supermarket concept right now. The specialty store is coming back. You see it in journalism. Specialty publications are killing the big national publications. You see it on television. The networks are losing to cable TV, home films and things.

I think in our industry, and certainly corporations, rarely use one purveyor of financial services. They use many. I feel as far as most investors are concerned, they like having several alternatives.

Senator RIEGLE. Are there any inherent advantages to one-stop shopping that you see?

Mr. JENRETTE. I really can't find any savings. They don't seem to have any synergistic effect in terms of operations. So I think in terms of savings in the economy they do little, and they just take away some of the diversity which was out of favor for a while but which I think the American people are getting back to where they want variety and diversity and not everything just alike.

Senator **Riegle**. If you don't see any particular additional gains, are there any jeopardies, or losses, or risks that go with it that you see?

Mr. **Jenrette**. Well, I think there are some losses in terms of creativity. Bigness generally tends to smother creativity and I'm not saying small is always beautiful, but I think right now we have a system where people can start their own firm, as we did 25 years ago, and the most creative people don't necessarily like to work for some of the big ones like the Deustchbunde in Germany. I'm sorry to keep picking on them.

Senator **Riegle**. Mr. Silver, what would be your view?

Mr. **Silver**. Perhaps I'm not quite as certain as my colleague. I think the jury is still out and will be out for a long time on one-stop shopping. I see all of the problems with it. In many cases you are mixing products which really don't necessarily go with each other. You don't necessarily buy a mutual fund at the same time you need life insurance. So the fact that they're all in one supermarket doesn't mean that there's any greater convenience.

The problems with it of course, is if you try to go into the one-stop shopping concept and mix banking with it, that creates a competitive problem for everyone else.

Now to give you an example, a Metropolitan Life Insurance salesman can't get me to buy his mutual funds by threatening not to sell me a Metropolitan Life policy, but he might be able to get me to buy his mutual fund if he wasn't going to renew my loan next year.

So when you put banking at the center of one-stop shopping, and that's what I tried to say in my testimony, you have a magnet for concentration of financial services, not only equities, but all financial services, that would be drawn right in like a vacuum cleaner. And I think the appendix to the SIA's testimony gives the data of what happened between 1927 when the McFadden Act legitimized bank entry into underwriting. In 1930, in 3 short years, they came to dominate debt underwriting.

I thought I had mentioned in our testimony, but we don't, that the term supermarket is not a new word. When one of the bankers was testifying back in 1933 as to why the banking crash happened he said one of the ideas was to create a financial supermarket. So the idea is not a new one.

Senator **Riegle**. Now I want to go back to something that was touched on earlier, and that is, if banks are currently offering discount brokerage services and securities firms are entering the banking business, wouldn't it seem that just fairness would dictate that you can't have it both ways? In other words, if you're going to keep the banks out of the securities business, you have to keep the securities companies out of the banking business. You commented on a question similar to that, Mr. Jenrette. You took the position that, in fact, that would be correct; if you're going to have the separation, you do have to try to back people out of this.

Mr. **Jenrette**. You can't have it both ways. I certainly agree with the chairman on that.

Senator **Riegle**. Mr. Silver, would you comment on that?

Mr. **Silver**. I would generally agree. If you find the necessity of moving the Glass-Steagall line one degree to the right or one degree to the left that is not necessarily significant, but obviously you can't go on breaching the walls without abandoning the field. So you do have to go one way ultimately or the other.

But whether we've reached a situation which is intolerable at this point, I don't know. I think there has been more heat than light. I'd like to know the assets of all the nonbank banks at this point. I know that I can tell you that most of the nonbank banks that were formed up to very recently had more to do with the attempts of investment advisers to have trust powers than anything else. I think these examples that keep surfacing are still examples, and whether the barriers have been breached for all time, I don't really know.

Senator RIEGLE. But I don't hear you saying in quite as clear terms as I heard Mr. Jenrette say that you would be prepared to set up a clean division here and if that meant backing people out of some business that they have already gone into your organization would be prepared to see that happen.

GROWTH OF COLLECTIVE FUNDS IN BANKS

Mr. SILVER. Well, we have, but I think that we have to go a little further because the focus has been only on the banking functions performed by the securities industry, the so-called nonbank banks. But nobody has really looked at the growth of the collective funds in banks. They are now $100 billion in size. I'm not talking about trust departments. I'm talking about collective funds. This has grown up over the years very quietly by a similar erosion of regulatory attitudes.

So if we're going to have a root and branch upheaval of these developments, let's have them take place on both sides of the fence.

Senator RIEGLE. So you say it's not so much an issue of moving Glass-Steagall one or two degrees either way, but a more fundamental question of taking down the historical separation. Could I interpret that to mean that if banks were allowed to get into revenue bonds and that was it, that was where the line was drawn for the next 50 years, that that would be a suitable way maybe to do this? I mean you could live with that?

Mr. SILVER. I'm not about to put Mr. Jenrette over the side first. I think I agree with the point he made earlier in his testimony, the securities business is an integrated business. You have mutual funds. You have revenue bonds. You have stockbrokers. If you start handing these powers over to the banks one at a time you have severely damaged the independent securities firms and you might as well then hand the rest over.

Senator RIEGLE. I have other questions here, Mr. Chairman. My time is up for now.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Mr. Silver, I want to follow up on the question which Senator Hecht asked and which the chairman interrupted and to which you posed to give an answer at some later time and see whether or not you can give me some hint as to what that answer would be. You deal toward the end of your written testimony with the anticoncentration provisions in S. 2181 and simply point out that the disproportion in size of capital between these large banks and mutual funds is so disproportionate that the very concept of the limitation is meaningless.

That may very well be true in some of the other concentration areas as well.

Now I suspect we're probably not going to be able to draw an anticoncentration provision which you are going to like because you don't want it allowed in any event. But assuming that the committee decides that it does want to authorize this kind of acquisition under some set of circumstances, first, can you devise a formula which would prevent undue concentration? Second, can you tell us now what aspects of either the bank or the mutual fund would it concentrate on?

Mr. SILVER. Well, I think it would have to—and I think your prefatory remark is right. You're asking me to answer that question from the grave, so to speak, but a formula would obviously have to focus on what one might call the mutual fund-like activities of the bank, and that is their collective funds and what we generically put under the title of the trust department activities because that would be the area of the concentration. And you're certainly right in your observation that the industries are of such disproportionate size that trying to draw concentration provisions in terms of the size may not make too much sense, but it also may lead you not to go down that road at all.

Senator GORTON. But some formula which could at least not allow a single bank to have a significant portion of all mutual fund assets could be devised.

Mr. SILVER. Well, Senator, I guess you're just saying who gets the breast and who gets the wing and who gets the leg, but, yes; I would think that you would have to concentrate on the size of the trust department and decide that you're comfortable with the disappearance of the independent mutual fund industry because that's what would happen.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Gentlemen, I want to make a comment first before I ask some questions. What I find of very deep concern in all of this is what I think is the complete failure to be thinking carefully about where we're going and what arrangements for structures we want to have in the financial industry, what the implications of that would be for the economy and indeed its impact would be in terms of power in the society.

Now part of the difficulty is that everybody says, well, why don't the various elements of the industry get together and develop a consensus. Now my perception is that each element is in there figuring, well, now, what can I do in this discussion on developing a consensus to further my sector and tradeoffs are there, without any thought about where it's all going to go.

Are we being drawn inexorably down a path toward a concentration in the financial industry in this country comparable to what exists in West Germany, or Great Britain, or Canada and, if so, what does that imply, not just for the industry but for the functioning of the society itself, for the concentration of economic power and decisionmaking in the society?

Of course, you're going to say, well, that's what the committee is supposed to do, and obviously there's a great deal of merit obviously to that.

One of the difficulties is that we are dealing with a lot of new technology, with a lot of expertise within the industry that ought to bear on the thinking of such a problem.

NEED TO LOOK AT THE BROADER TERMS

So I've been wrestling a bit with how we develop a process that may address those long-range questions? We have really got to examine the breaking down of these long-standing divisions, many of which had good reason when they were put into place. There are still good reasons for them or there aren't good reasons, but I don't know that anyone is really thinking in the broader terms that I'm talking about.

Let me ask you this question about blue ribbon panels. The President has used them repeatedly, perhaps too much. Nevertheless, perhaps there is merit in some effort to structuring something that would include leading members of the various sectors in the industry, plus representatives of the public at large and perhaps congressional people as well. They could wrestle with the question of what kind of structure do we want over the long term, and for what reasons.

We've got to get beyond the point of one industry saying merely, well, if I could get that and protect myself from this, while another sector is saying just the reverse, and no one is looking at where all of that is taking us. There are really some very broad public interest considerations at stake—the concentration of economic power, the concentration of decisionmaking or the shifting of decisionmaking away from local and regional bases to a few money centers in the country, the movement of funds, the quality of access to credit.

Let me ask you if in your opinion there is any kind of process that might be better able to address these questions than the process I think we've been following?

Mr. **Jenrette**. Well, I think the process of this hearing and the chairman's efforts to get certain members to sit down, if he keeps whacking us around long enough, maybe sooner or later we'll get this resolved. But I think the alternative to hearings such as this, where we all present our views, would be a special study group focusing on the issues of concentration of power, which I guess ultimately I feel is the issue.

As Mr. Silver has mentioned, the control of credit is so central it's like a magnet. I think that was the term he used. You've got the Federal Government guarantee given to the banks and this ability to raise trillions of dollars on the Government's credit. It's just an awesome power which could quickly lead to further concentration of power—such as through additional investment assets managed by banks through trust departments, including pension funds and mutual funds. If in turn you also put in between that the underwriting functions where banks control not only short-term credit but also control pension funds and mutual funds, it's just one big monolith. I think creativity suffers and there would be excessive concentration of power in the banks. Corporate America would be the loser. I think the consumer also would be the loser in the long run through services and prices going up.

While this wouldn't happen overnight, I think it's a road we would be getting to. Some future Garn-St Germain Act might find it necessary to separate trust departments from banks. But I think somewhere down the line Congress will end up with the decision to separate the total financial marketplace—it's just too big, all lumped into one industry, if you can call it an industry.

Mr. **Silver**. I would like to comment, Senator. There have, of course, been studies in the past and one can argue that there have been enough studies, but I would point out that the studies in the past—the Hunt Commission comes to mind particularly—have focused on bank deregulation. They have focused on the relationship of the banking industry to the savings and loan industry. The focus of those studies have always been in that direction.

There has never been a group commissioned and mandated to study the specific issues you're talking about as to what does the world in the future look like if you put insurance, if you put the securities business, and you put banking in one pot. No group with significant input from either the securities or the insurance industries has ever been commissioned.

Naturally, the older commissions which studied banking deregulation came to the conclusion that banks should be deregulated, but there was never significant input from the other affected industries and, likewise, there has never been a study of this broader issue with significant public input and, as I tried to say, I was amazed at the inability of our very good research department to gather basic elementary statistics in this area.

I think both from a policy point of view and a data point of view a commission would be a good idea.

Senator **Sarbanes**. It's always discussed as though Glass-Steagall represented some new concept in separating commercial banking and professional banking. My recollection is that separation was the prevailing concept throughout most of our history and that to the extent we departed from it it was in the period leading up to the difficulties then resulted that in Glass-Steagall, which reaffirmed past views and experience. Is that correct?

HISTORY OF BANKS CONCERNING COMMERCIAL INVOLVEMENT

Mr. **Silver**. That's correct, Senator. The National Banking Act of 1863 was interpreted by the courts during the remainder of the 19th century and then by the Solicitor General and attorney general in 1911 as precluding bank entry into the securities business. There were a stream of Supreme Court cases on this in the 19th century. In fact, we do follow the English model and if you will indulge me for one second I might mention that this goes back to the charter of the Bank of England in 1694 which specifically prohibited that bank from going into commerce. That's the tradition we inherited and it has worked very well.

The period between 1927 and 1933 was an aberration.

Senator **Sarbanes**. And I ought to elaborate on a previous reference. When I made reference to the British and German models, I was thinking back to the McFadden Act and its effects on the arrangements within the banking industry. That is another issue that needs to be carefully examined. I'm not at all certain—in fact, I have a lot of doubts—that limiting a bank's activities to one county in a State makes sense. On the other hand, I'm not sure that the alternative to that is to move to a nationwide banking model. If that is the choice, we may then move down the path in which a handful of banks located in the country's major money centers will dominate the banking industry.

This isn't even addressing the question of its relationship to investment banking or insurance. We may need some kind of regional or State arrangement, or something of that sort.

Again, I don't see that this question is being thought through. It ought to be thought through, it seems to me, as part of thinking through the relationship between the banking sector and the other sectors that are involved. Of course, that addresses the nonbank banks as well, which are moving in the other direction.

There are important questions here of safety for the public, of access to credit. I have a lot of difficulty with retail shops running banks, to be very blunt about it. Maybe I'm just being old fashioned. Maybe somebody can look at it and develop a rationale that says, look, this is going to work, the consumer gets benefits out of it and there aren't any downsides or risks to it. But the point is, no one is doing that kind of thinking. I think it needs to be done by the industry itself, along with the Congress.

Industry representatives need to be part of a process where they have to address some of these broader questions, even if that may mean going at one another very hard for a period of time. But they need to start identifying these questions, analyzing them and beginning at least to see what the consequences would be.

Then you can make a responsible judgment about down which path we want to follow, where we are going to end up. Now we're moving down paths with no one figuring out where they will take us. Eventually, when we get wherever it is they're taking us, a lot of people are going to turn around and say, we're not sure we ever really wanted to come here; this may not be the best thing for the country. At that point the eggs will have been broken, so to speak, and we're not going to be able to put them back together again.

I think that's very fundamental to the consideration of this issue.

Thank you, Mr. Chairman. I see my time is up.

The CHAIRMAN. May I just make a quick comment and then have time for one more question. I would advise the members of the committee we have seven more witnesses and we have gone through two in 1½ hours.

May I say to the Senator from Maryland that I agree with virtually all he has said. He's a very thoughtful, articulate member of this committee and the issues are very broad and the only trouble I have with his statement—I agree with the whole thing he has outlined of what we need to be looking at, but I would suggest that is the process we have been attempting to go about, and to force people to look at things. I have been jawboning industry for so long. Each of you knows that. Not in terms of the narrow focus of getting together and talking about trade-offs. The Senator from Maryland is absolutely correct. We don't deal with issues of this magnitude on that basis.

When I say get together and achieve a consensus, I'm not talking about a bargaining where you say you take this service and you take that one. I think all of you would agree with that.

Senator, I spent virtually 3 years of my life virtually full time trying to push Congress and these industries into exactly the type of deep look at the longer term picture because it has not been done. So you're absolutely correct in the direction we are going. That's why there have been thousands of pages of hearings every year. We have rehashed. We have repeated. And I think that is a direction that this committee should try and force the issue in the longer look and there are a lot of people thinking in that direction.

Certainly I've had more contact with Mr. Silver than Mr. Jenrette and we've had many conversations about the longer term future, as I have with a lot of people.

So I want to agree completely and totally with what you said about the nature of the problem and only disagree from the standpoint that there aren't some people thinking about that and trying to work together in a consensus to focus on that.

Senator SARBANES. Mr. Chairman, I recognize the yeoman work you've been doing and I have great respect for it. I guess what I'm really suggesting is that perhaps we should be thinking of a process where the witnesses who appear before us and to the committee, who come to us with statements but to some extent pass one another like ships in the night, ought to be part of a broader group embracing perhaps Members of the Congress as well. In that framework they can go at one another and have a chance to explore a lot of the facts and the procedures and the developments in the industry—in a way exploring with one another, perhaps even against one another—so we can see exactly where we're going and what the implications of it are.

The CHAIRMAN. Well, I agree and I understand and I wasn't looking for somebody to say you're doing yeoman work, that was not my point in bringing this out. It happens to be my responsibility to try and do yeoman work as chairman of the committee. My point was that I appreciate you bringing it up and I agree and I appreciate the statement and would hope they would get together in whatever position they could.

The major point I wanted to make is simply that in that context they should get together and I agree with the Senator, not in a trading situation of who gets what without regard to the implications of that to the general public of this country.

Senator Riegle.

Senator RIEGLE. Mr. Chairman, I'll be very brief. As you say, we have a number of witnesses including Don Treadwell from the realtors who comes from my State of Michigan and we are anxious to hear from him and the rest.

I want to cover two things before we finish with this panel. First of all, I have a series of additional questions that I would like to have you respond to for the record and I will see that you receive those today.

I just want to say that I think we ought to be acting this year in this committee. I think there are specific nagging problems that have been identified that are clear special problems. John Heinz referred to a couple of them that I think we can deal with or we should attempt to deal with this year.

I'd like to see the committee as a whole try to deal with all these issues. I respect what my colleague from Maryland said and I think that's right, that we might gain something if we had a different kind of a chance for people to talk about this, but we've been around this track a number of times and I think the issues are fairly well known now and I think in a sense we've got to find out at some point where the committee is, where the Congress is, and see if we can't vote on these issues and settle these issues as best we can. There is no perfect answer. It's going to be a question of sorting out all the differing arguments and trying to make some kind of balanced judgment, but I think the Congress has an obligation to do that this year and I hope that we will do it this year and I think these hearings help us substantially move to the point where we can make those judgments and try to sort out the equities and the questions.

WHAT IF BANKS MOVED A NOTCH FURTHER—INTO REVENUE BONDS

We ran out of time there at the end and I had posed the question of whether if the banks were to be moved a notch further into the securities business in terms of revenue bonds, what are the implications of that? If one knew that that would be then a new line that would be drawn but would last for decades, at least in terms of the hypothetical I'm posing, let me ask you, Mr. Jenrette, how significant would that be? What would you see that as meaning in terms of implications for those that you represent?

Mr. JENRETTE. Well, it's very significant. The sale of tax exempt bonds now exceeds the sale of corporate bonds and, as we tried to convey before with this magnet power to control deposits, there's no doubt in my mind that the banks would preempt the revenue bond market. This would be a big loss to our industry, would weaken our sales distribution system. So it would be like lopping one-fourth of our business off.

Senator RIEGLE. In other words, it would be a strategic change. It would fundamentally alter the relationship in those sectors.

Mr. JENRETTE. It would not be that significant for a much larger commercial banking industry.

Senator RIEGLE. One of the questions I'm not going to necessarily have you respond to now, but I do want to have you respond in terms of the rationale for the separation of the securities activities from banks that this would insulate more risky activities from the banks' insured deposit base and what those funds are used for, and I would like to know if you in your view—and obviously you have an economic interest involved here, but as you see that question, in your view, is there a way that those activities can ever be adequately safeguarded even assuming you're in a separated affiliate? Is there really a way to safeguard against the risks that tend to be attached to the securities business broadly defined?

Mr. JENRETTE. I don't believe there is, even through a separate subsidiary. I think if the bank has a loan outstanding to a company and there's a need to raise equity capital to pay off the loan, the bank will have strong incentive if there are some problems emerging in the company to sell stock to the public and pay off its own loan, whereas if you have an independent securities industry they don't have that conflict. The company has to make its case, why it's creditworthy and should sell equity, and this is the kind of thing the Chinese wall could never overcome. An independent investment banking industry would not underwrite the company unless it believed the securities were valuable and the company was viable. We're saying there's a great temptation if they've got a big loan out to the company to sell stock and take your money out of the situation. So it's a tough conflict to handle and even if you handle it well, if you had some kind of economic crash, it's somewhat incestuous and you're going to be severely criticized.

Mr. SILVER. I have two sentences, if I may, Senator. I think the experience of the 1920's proves that the affiliate didn't work and the REIT's more recently proved that the affiliate didn't work. I would say about FDIC I think there was, if not an expressed, an implied trade-off. The banks were going to get and the public was going to get Government insurance, but the banks were going to stay out of risk businesses.

Senator RIEGLE. Well, I thank you and in the interest of time I think we have to stop here.

[Response to written questions of Senator Riegle follows:]

ANSWERS TO QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR DONALD W. RIEGLE, JR.

FROM: RICHARD H. JENRETTE, Chairman, Securities Industry Association

Q. In the past, the Dealer Bank Association has argued that if banks could underwrite revenue bonds, municipalities would save money. What is your response to this argument?

A. The assertion that muncipal bond issuers would save money if the Glass-Steagall Act were amended to permit commercial banks to underwrite presently ineligible revenue bonds has been analyzed in numerous congressional hearings since 1963 and consistently refuted. The most exhaustive analysis of the claimed savings occurred during lengthy hearings before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance in 1979. Those hearings focused on a statistical study conducted by Professor Phillip Cagan (and sponsored by the Dealer Bank Association) which estimated that the present value of interest savings for ineligible revenue bonds issued in 1977 would have been $412 million, and the responses thereto, prepared at the request of the SIA, and presented by Professor Michael Mussa, University of Chicago, and Professor George G. Kaufman, Loyola University of Chicago.

The main conclusions of the studies of Mussa and Kaufman are that:

- bank eligibility has had no statistically significant effect on the interest costs of negotiated revenue issues;
- bank eligibility has had no direct statistically significant effect on the interest costs of competitively sold revenue issues;

- there is no reliable or convincing statistical evidence that bank eligibility has increased the number of bids on revenue bonds sold competitively; and
- there is no statistical evidence that interest yields on eligible bonds have behaved differently than yields on ineligible bonds as the bonds move from the primary market to secondary market.

In sum, no convincing statistical evidence was found to support the claim that permitting commercial banks to underwrite municipal revenue bonds would result in any cost savings to issuers. It is clear from the Mussa and Kaufman studies that comparable bank eligible and bank ineligible bonds sell at statistically indistinguishable interest rates. These two studies have been made available to all, including government agencies, and, to the best of my knowledge, no one has found any errors in either the statistical analysis or in the conclusions.

Since the publication of the critiques by Mussa and Kaufman of the Cagan study, the Dealer Bank Association has abandoned its reliance thereon in favor of a new study of interest savings written by Professor William Silber. The Silber study, however, does not present any new factual evidence of statistical results; it simply reviews the results of other studies written prior to October, 1979. The Silber study was also convincingly refuted by Mussa during hearings before your Committee in October 1981.

In concluding this answer, I call attention to the existence of more than 800 firms underwriting and dealing in municipal securities, a fact which should establish per se that issuers enjoy the full benefit of competition in both the primary and secondary markets. Moreover, there is complete freedom of entry into the business by new firms subject only to the restriction that underwriting certain kinds of revenue bonds cannot be combined with commercial banking in the same enterprise.

Q. If the Congress allowed banks to underwrite revenue bonds, what advantages -- if any -- do you think they would enjoy over securities firms?

A. Any contest between a bank and a non-bank is inherently anticompetitive. A bank's special advantages - provided to them in their role as banks - are unfair and destructive of effective competition when used outside of the field of banking. This fact has been recognized by the Congress in enacting the National Banking Act of 1864, the Glass-Steagall Act and the Bank Holding Company Act, all of which confine the range of commercial banking activity.

The key difference between a bank and any competitor is a bank's ability to take deposits to use in its own business - federally insured deposits at that - resulting in readily available and inevitably lower cost capital for all of its endeavors. In addition to a lower cost capital, other advantages held by banks include favorable tax treatment, the availability of captive markets, e.g., their investment portfolios, trust departments and correspondent banking relationships. In addition, banks have the ability to tie the extension of credit to the purchase of other banking services.

Q. The following concerns have been raised regarding bank involvement in the securities industry:

(i) The potential for conflicts of interest.

(ii) The potential for illegal tie-in arrangements.

(iii) The potential for marketing and advertising advantages.

(iv) The potential for undue concentration of economic power.

(v) The transfer of funds and the potential effect on local and regional economic development.

(vi) The potential effects on the safety and soundness of depositors' funds and on the banking system.

(vii) The potential effects on the availability of new investment and risk capital.

(viii) The potential unfair competitive advantages commercial banks would have acting as stock brokers because of their government insurance tax status and access to Federal Reserve loans.

Which do you take most seriously and how would you address them?

A. All concerns identified in your question are serious. Perhaps the gravest consequence is (vi) "the potential effects on the safety and soundness of depositors' funds and on the banking system." In this regard, my attention has been called to the opinion of the Supreme Court in Investment Company Institute v. Camp, in which Justice Stewart wrote:

> "In sum, Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment banker's pecuniary stake in the success of particular investment opportunities was destructive of prudent and distinterested commercial banking and of public confidence in the commercial banking system. As Senator Bulkley put it: 'If we want banking services to be strictly banking services, without the expectation of

> additional profits in selling something to customers, we must keep the banks out of the investment security business.'"401 U.S. 617 634

I also view most seriously the potential for undue concentration of economic power (iv) and the potential effects on the availability of new investment and risk capital (vii) if banks become involved in the securities industry.

The most effective way to address these problems is not to permit them to arise in the first place as the consequence of lax enforcement of existing law and the exploitation of various "loopholes".

Q. We hear a great deal these days about the need for a new national policy for our financial institutions. Do you believe that our laws need updating and if so, what are the problems and how would you address them?

A. In my opinion, the fundamental principle embodied in the Glass-Steagall and Bank Holding Company Acts, that commercial banking should be separated from investment banking and other lines of commerce remain as sound and important today as when these laws were enacted. Any change should be in the direction of applying the separation principle to other depository institutions and making the Glass-Steagall Act applicable to non-member state banks.

Q. What specific directives would you recommend we give the bank regulators and why?

A. I would recommend that the bank regulators maintain a moratorium on the granting of nonbank bank charters and on allowing depository institutions to engage, directly or indirectly, in securities activities not clearly provided for by law until such time as the Congress is able to conclude a comprehensive review of the appropriate statutes and enact whatever changes are deemed necessary.

Q. Part of the rationale for separation of securities activities from banks is that this would insulate risky activities from the bank's insured deposits. Do you believe these activities can ever be adequately insulated?

A. No. I addressed this question in my prepared testimony on pages 13-15, quoting Mr. Walter Wriston, Chairman of Citicorp, Chairman Volcker and Professor Nelson Peach. They all agree that as a practical matter a bank must stand behind its affiliates. To quote Mr. Wriston: "If your name is on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the market place is persuasive, and would not see it that way."

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DAVID SILVER
PRESIDENT

April 9, 1984

Honorable Donald W. Riegle
United States Senate
Washington, D.C. 20510

Dear Senator Riegle:

The following are my responses to the questions for the record which you submitted to Richard Jenrette, Chairman of the Securities Industry Association, and me.

1. "In the past, the Dealer Bank Association has argued that if banks could underwrite revenue bonds, municipalities would save money.

- What is your response to this argument?
- If the Congress allowed banks to underwrite revenue bonds, what advantages -- if any -- do you think they would enjoy over securities firms?"

The Securities Industry Association is expert with respect to the underwriting of municipal revenue bonds and we therefore defer to Mr. Jenrette's response to your specific questions. However, each additional securities power banks are given weakens the nation's network of independent securities firms on which business as well as municipalities depend for the effective and efficient distribution of their securities.

Moreover, we would point out that bank attempts to obtain authority to underwrite municipal revenue bonds are but one example of efforts by the largest banks to utilize limited exceptions in the Glass-Steagall Act as opportunities to expand into more general securities activities. Thus the justification for proposed expansion of bank powers is based on narrow, specially justified exceptions from Glass-Steagall: the underwriting of municipal revenue bonds (from the limited exception to underwrite municipal general obligations); brokerage activities (from a limited accommodation service for pre-existing bank customers); and, sponsorship and mass-marketing of common and collective funds (from the ability to commingle _bona fide_ pre-existing individual trusts solely for purposes of administrative convenience).

Finally, an issue which deserves critical study before expanding bank powers to encompass the underwriting of revenue bonds is the activities of New York banks with respect to New York City obligations during the New York City financial crisis.

* * *

2. "The following concerns have been raised regarding bank involvement in the securities industry:

(i) the potential for conflicts of interest.

(ii) the potential for illegal tie-in arrangements.

(iii) the potential for marketing and advertising advantages.

(iv) the potential for undue concentration of economic power.

(v) the transfer of funds and the potential effect on local and regional economic development.

(vi) the potential effects on the safety and soundness of depositors' funds and on the banking system.

(vii) the potential effects on the availability of new investment and risk capital.

(viii) the potential unfair competitive advantages commercial banks would have acting as stock brokers because of their government insurance tax status and access to Federal Reserve loans.

* Which do you take most seriously and how would you address them?"

Seriousness of Problems

From the point of view of the mutual fund industry, the most serious problems are presented by items (ii) tie-ins; (iii) marketing and advertising advantages; and (viii) unfair competitive advantages. From the point of view of overall national public policy, the most serious problems are presented by items (i) conflicts of interest; (iv) undue concentration of economic power; (v) the transfer of funds; (vi) safety and soundness; and (vii) the availability of new investment and risk capital.

Addressing Problems

(a) Regulatory Problems

The abuses which occurred when banks and their affiliates sponsored investment trusts (mutual funds) in the 1920s and real estate investment trusts in the early 1970s indicate the types of regulatory problems which are likely to reoccur if bank holding companies are permitted to sponsor and distribute mutual funds. These bank abuses have never been the subject of remedial securities legislation. Both SEC Chairman Shad and the North American Securities Administrators Association have testified before your Committee that these regulatory problems would not be remedied simply by subjecting bank mutual fund activities to regulation under the existing federal securities laws. Congress enacted these laws based on the assumption that the Glass-Steagall Act prohibited banks and their affiliates from engaging in the mutual fund business. Therefore, while the existing federal securities laws address specific regulatory problems which are likely to arise when investment banking firms, broker-dealers and investment advisers sponsor and distribute mutual funds, they do not seek to address the unique regulatory problems which are likely to arise if banks or their affiliates are authorized to engage in these activities.

We have provided the Department of the Treasury with a series of amendments designed to deal with specific regulatory problems. A number of our suggested amendments are designed to deal with the regulatory problems set forth in your question.

- Item (i) (Conflicts of interest) -- is addressed by:
  - Amendment D -- "Prohibition Against Use of a Bank's Name by its Securities Affiliate and Affiliated Mutual Fund"

  - Amendment E -- "Lessening of Public Confusion Between Banking Functions and Affiliated Mutual Fund Activities"
  - Amendment F -- "Prohibition Against Overlapping Personnel"
  - Amendment H -- "Prohibition Against Dumping of Affiliated Mutual Fund Securities Into Bank Fiduciary Accounts"
  - Amendment I -- "Prohibition Against Manipulation of Affiliated Mutual Fund to Facilitate Loan Payments to Banks or to Assist Correspondent Banks"
  - Amendment J -- "Prohibition Against Bank Loans to Securities Issuers to Support Affiliated Mutual Funds"
  - Amendment K -- "Prohibition Against Loans by Banks to Enable Customers to Purchase Securities of Affiliated Mutual Funds"

- Item (ii) (tie-ins) -- is addressed by: Amendment G -- "Strengthening Anti-Tying Provisions".

These proposals are not based on abstract theory but on an historical record of grave abuses. If the Committee determines to proceed with legislation authorizing bank holding companies to sponsor and distribute mutual funds, we sincerely hope that it seeks to address the regulatory problems you have mentioned, and considers all of our proposals in this regard. The amendments we propose may serve to fashion remedies for specific regulatory problems, but the more difficult task is to assure free and open competition.

(b) Competitive and Economic Problems

The other problems set forth in your question stem from the advantages granted to banks by government in order to assure a safe and sound banking system and assure the credit needs of business and individuals in all sections of the country. For example, banks are provided FDIC deposit insurance and access to the Fed discount window and the Federal funds market. The McFadden Act and the Douglas Amendment restrict entry into local markets to the advantage of local banks. Each of these advantages are based on reasonable public policy considerations. But these policy considerations have never been measured against the anticompetitive effects and the economic consequences that arise whenever banks bring their unique advantages to bear in other lines of commerce.

Our testimony of March 7th discussed one area where this has already occurred -- bank investment management services. There is ample evidence that corporations and other investors select banks to manage their money in order to enhance their relationships with the commercial (e.g., lending) side of the bank, despite inferior investment results. Despite their generally inferior investment performance, bank trust departments dwarf the mutual fund industry in size. Even exclusive of personal trusts, at year-end 1982 bank trust departments managed assets of $480 billion as against the mutual fund total of $77 billion (exclusive of money market funds). The top five banks alone held approximately $54 billion in equity securities, an amount similar to that held by the entire mutual fund industry.

Now it is proposed to extend bank powers to permit them to sponsor and mass-merchandise mutual funds, where the potential for increased tie-ins and "bundling" exists. Aside from the fact that this extension will have a devastating effect on the mutual fund industry -- both on those who manage mutual funds and those who sell them -- there are other public policy problems outlined in your question.

Bank entry into the mutual fund business would greatly increase the equity holdings of the banking sector. Over the long run, concentration would increase because banks would steadily build equity portfolios in tandem with their control over the investment policies of stock mutual funds. Initially, however, these equity holdings would expand sharply as large banking institutions move quickly to acquire large mutual fund advisory organizations. For example, if the top 20 bank holders of equities were to acquire the top 20 mutual fund advisory organizations, they would add about $100 billion to their equity holdings (at portfolio values that prevailed in mid-1983). These additions would dramatically balloon bank concentration in holdings of the stock issues of individual companies and industries.

As a result of the special privileges conferred on banks by government, the financial services industry in this country will be centered around a few giant banking organizations. In short, the pending legislation would act unwittingly as a tremendous engine for the concentration of both equity holdings and financial services in banks. It thus gives rise to all of the problems set forth in items (iii) through (viii) of your question.

In order to deal with these problems, proposed legislation should not simply expand bank powers into new areas while continuing to protect banks from competition, but also should permit securities firms, insurance companies and other firms to enter the banking business on a nationwide basis. There is no other way to prevent the competitive and economic problems listed in your question.

3. "We hear a great deal these days about the need for a new national policy for our financial institutions.

* Do you believe that our laws need updating and if so, what are the problems and how would you address them?

* What specific directives would you recommend we give the bank regulators and why?"

The principles underlying our laws governing financial institutions are as sound today as they were when first enunciated in the National Banking Act of 1863 and in subsequent legislation such as the Glass-Steagall Act and the Bank Holding Company Act. As indicated in my response to your first question, current problems derive from decisions of the federal banking agencies to disregard those policies and to attempt to rewrite the laws through their administrative actions.

Congress can respond to this situation in one of three ways. First, it can do nothing and permit the administrative agencies to continue to undermine the historical national policies set forth in existing law. Second, Congress can restore the efficacy of those policies by enacting legislation closing the loopholes sought to be created by the action of the federal banking agencies and by directing the regulators to enforce the laws consistently with Congressional intent. Finally, Congress can decide to reverse historic national policies and to permit commercial banks and their affiliates to engage in other activities. But if Congress determines to pursue this latter route, it is essential that Congress simultaneously address both the regulatory and competitive problems set forth in your first question. While it is possible to identify and to attempt to address the regulatory problems, assuring free and open competition is far more difficult and requires legislation which would not only permit banks to engage in non-banking activities, but which also remove the special protections heretofore accorded to banks and permit non-banking firms to engage in the business of banking.

Before taking such a momentous step, Congress should undertake a detailed, dispassionate study of the likely consequences, not only on the banking industry but on the securities industry and the economy as a whole. Pending completion of such a study and the enactment of major reform legislation, it will be necessary to enact interim legislation designed to prevent further regulatory erosion while Congress completes its work.

4. "Part of the rationale for separation of securities activities from banks is that this would insulate risky activities from the bank's insured deposits.

* Do you believe these activities can ever be adequately insulated?"

As a theoretical matter it may be possible to devise statutory provisions which legally insulate risky activities from a bank's insured deposits. Indeed, a number of the proposals which we have made and which are summarized in my response to your second question, are designed to achieve such legal separation.

However, as a practical matter, it may be impossible to guarantee that insulation will work when problems develop. Mr. Walter Wriston, Chairman of Citicorp, testified before your Committee on October 29, 1981:

> "If your name is on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way."

Chairman Volcker in testimony before your Committee earlier this year in Salt Lake City similarly stated that: "...a bank or depository institution cannot be wholly separated from the fortunes of its affiliates and from the success or the failure of their business objectives."

I hope that the foregoing is responsive to your questions. Should you have additional ones, please do not hesitate to call me.

Very truly yours,

David Silver

David Silver

The **Chairman**. In the interest of the other seven witnesses we have to stop. Gentlemen, thank you very much. We appreciate your fine testimony today.

May we quickly have the next panel come up. Gentlemen, we appreciate your patience very much. When we scheduled this many witnesses in one morning we did not anticipate the first panel would take so long and we do appreciate your willingness to wait.

The second panel is composed of Mr. Donald H. Treadwell, president, National Association of Realtors; president, Treadwell Real Estate, Southgate, Mich.; Mr. John M. Teutsch, Jr., chairman, legislative committee, Mortgage Bankers Association; president and chief executive officer, Rainier Financial Services, Seattle, Wash.; and Mr. John Koelemij, first vice president, National Association of Home Builders.

Gentlemen, we are happy to have you with us. Mr. Treadwell, would you like to begin, please?

STATEMENT OF DONALD H. TREADWELL, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS; PRESIDENT, TREADWELL REAL ESTATE, SOUTHGATE, MICH.

Mr. **Treadwell**. I will summarize my statement rather than reading the entire statement which has been submitted.

The **Chairman**. I will guarantee all your full statements will be put in the record.

Mr. **Treadwell**. Thank you. My name is Donald Treadwell and I'm a realtor from Detroit, Mich., and president of the National Association of Realtors, which presently represents approximately 625,000 realtors throughout the United States. For several reasons which I will elaborate on during my testimony, it is the position of the National Association of Realtors that depository institutions should not be granted the authority to engage in third-party real estate brokerage.

FUNCTIONS OF A REAL ESTATE BROKER

First, let me tell you what the functions of a real estate broker are, because I think there is a lot of misunderstanding in that area. The basic service a real estate broker provides is marketing and counseling in the sale or purchase for a home for a seller. The second function is to lead the parties through the intricacies of the real estate transaction with which they are normally not familiar, a transaction, which they probably would only engage in a few times during their lifetime. And third, we assist them in determining what the availability of funds are so that they can finance the transaction, which of course is a major portion of the activity.

Recently computerized programs that the national association has begun such as the realtors national mortgage access program, has raised some confusion about real estate brokers assisting financial institutions. So that the banking function is something that the real estate association is not getting into and we have no intention at this time. We intend to have the lenders continue their function as they have in the past.

We do recognize that some real estate firms have established affiliation with mortgage companies but these are distinguished from the banks and the savings and loan associations because the mortgage companies do not have any of the subsidies or competitive advantages under the State and national State system which is the deposit insurance, et cetera.

We support this activity as long as there's a full disclosure of any possible relationships that the real estate brokers might have with the mortgage company. I think the Federal Reserve Board has affirmed the position of the impermissibility of general real estate brokerage in a bank holding company. So we feel there has been in the past a separation of these and we see it continuing in the future.

I would like to differentiate for you the distinction between a real estate broker and other types of commerce because I think this is a distinction which has been overlooked in all the discussions to date. There has been a great deal of financial risk for the public. Third party real estate brokerage firms are subject to a maze of State regulations and State laws. For example, under State law, real estate brokers must meet various licensing and education standards and remain subject to public grievance procedures.

But I think even more fundamental than that, the distinction which comes from common law and the State statutes and the customs in the industry and certainly from a code of ethics, the real estate brokers have an agency relationship with usually the sellers and occasionally the buyers, but with one of the parties to the real estate transaction.

Joining a bank and a real estate company raises extremely serious questions of conflict of interest which I think do not arise in many other forms of commerce. I believe that that distinction should not be overlooked in our discussions.

The fundamental issue, of course, which we are all concerned with here is the safety and soundness of our financial institutions. That has to be the first objective of any of our new legislation, but I would point out in summary that the world has long been full of entrepreneurs who are seeking to obtain control over vast amounts of low-cost capital. It's historically obvious that banks have traditionally been the sources of the lowest cost capital and this is due in large part because the banks in the past have been forced to limit their risk taking so that in turn they could have a lower loss and accept funds at lower rates.

Precipitively eradicating the boundaries which have been erected between banks and other forms of commerce does not appear to me and to our association to be in the best interest of the public at this particular time. I think a review of the recent record supports this. The Penn Square failure, the collapse of the Butcher banks in Tennessee, Chase-Manhattan Drysdale securities debacle, and even the recent $8.4 billion IMF increase of appropriations which assisted in bailing out—or at least in refinancing and refunding international debts which major banks entered into, I think all attest to the fact that there's a great deal of risk in many of these activities.

One of the most recent threats to the safety and soundness of the system stems from the money market brokers who broker deposits, seem to be ending up many times in failed institutions. This is another example of the failure of the regulatory structure to keep up with events in the market. Depository institutions are getting into trouble in this area too quickly for regulators to be aware of it and the possibility exists of providing a warning signal which could by itself push a marginal institution over the line into failure. I would point out that even the national association disperses funds around in lots of $100,000 in various banks and there is more concern that the bank be insured and that the deposit be insured than there is in investigation of the soundness of the particular institution that they are put into.

I'm assured by all my friends and associates that that is a very common practice in all types of commerce today.

But let us not forget that the current laws were enacted to keep depository institutions out of areas not closely related to banking because when depository institutions made bad decisions the public and the economy suffer the consequences.

The claim that we should bring banks into the real estate brokerage business in order to enable them to improve their safety and soundness by increasing their profits runs contrary to experience. We would point out in times where there is high interest or in times of depression certainly real estate brokerage firms are hardest hit. The drop in gross sales in the country from the high to the low recently was 55 percent. Certainly banks which were depending upon real estate brokerage activities to bring them through the past few years would have found that they were a steady drain on their capital. Certainly that excuse does not bear investigation.

SEPARATE AFFILIATE STRUCTURE WOULD NOT WORK

It's been suggested that we have a separate affiliate structure and therefore we could isolate the real estate brokerage activities from the other activities of the bank. The national association strongly disagrees. We feel that that would enable them to isolate themselves from the problems that have come up.

I think statements have been made by the past witnesses that indicate the potential tie-in in this area. I would submit to you in summary that it is not enough that holding companies—that most holding companies all of the time or that all holding companies most of the time would maintain a proper separation between the bank and the real estate brokerage function.

The industry should be structured so that we would minimize both the temptation and the possibility to have self-dealings or dealings on any other basis than pure market evaluation of the value of the loans that are being made.

Potential riskiness of the nonbanking activities is relevant to the public's perception of the safety and soundness of the deposit institutions and if we find, as we've found in many of the cases in the past—American Express and others—that there was a concern over the holding company or the parent organization due to the problems that have arisen in terms of one of the subsidiaries.

We look at the experience of the REIT's, which has been referred to, that illustrates the problem and I don't see any reason of repeating the remarks of one of the previous speakers, with which I would agree.

Some people have argued that section 23(a) of the Federal Reserve Act permits a bank to loan only 10 percent of its capital and surplus to a nonbank affiliate and therefore that would provide adequate insulation. I would submit to you that 10 percent of the capital and surplus of a very large number of banks would exceed by several times the total capital of a substantial number of our small firms in the real estate business—not substantial, but for most of the firms in the real estate business, 10 percent of bank's capital and surplus would permit them to stay in business during high interest rate and recessionary cycles while independent brokers would be forced to close up shop. So when you put in such a measure as that it's absolutely no protection whatsoever.

Last, I would like to indicate what we feel is perhaps the most serious fundamental difference which is perhaps pulled together from some of the things that have been said here in the past.

No. 1, there's no question in our minds that the Federal subsidies and competitive advantages which are given through FDIC insurance, access to the reserve window, tax advantages, et cetera, permit banks a tremendous advantage in accumulating a large amount of capital. We find that if this capital is going to be made available to a real estate firm or its customers on a preferential basis that this is devastating as far as the concentration of industry and the ability to compete.

We would point out to you what has already been happening in the States of Iowa and Nebraska, matters which have been called to the attention of the Federal Home Loan Bank Board with no response from them from a regulatory point of view, even though there is apparently severe question whether or not these are in conflict to the rules and regulations.

But advertising which indicates to the public that there would be some specific advantage in the financial side of the real estate transaction if they were dealing with a broker where there is a linkage; we find advertisements which are submitted along with some of the information I've given you where certainly the perception given the public is there is in fact going to be some advantage if in fact they deal with this particular broker.

Looking at it in particularly the small communities around the country where a single bank or financial institution dominates the local finances, it would make for almost a guaranteed concentration of activity. Certainly the market share of the brokers affiliated with the bank would increase largely.

I think we are back in the dilemma where either there is some tie-in arrangement where benefits are going to be passed through. In those events where there is not, certainly there's been misrepresentation to the public in advertisements which tend to indicate there would be.

So I feel we are in a dilemma in this situation and it's impossible to keep them separated. For this reason, we feel very strongly that the ultimate bottom line is that financial institutions which are given subsidies and competitive advantages of various forms by the Federal and State Governments should not be permitted to move into the real estate brokerage business on a third-party basis.

I appreciate the opportunity to testify before you and I'd be glad to respond to any questions you have.

[Complete statement follows:]

STATEMENT

of Donald H. Treadwell

on behalf of the

NATIONAL ASSOCIATION OF REALTORS®

before the

Senate Committee on Banking, Housing

and Urban Affairs

Mr. Chairman, my name is Donald Treadwell and I am a REALTOR® from Detroit, Michigan and am President of the Association. I am here on behalf of over 600,000 members of the NATIONAL ASSOCIATION OF REALTORS® involved in every facet of real estate. I would like to thank you for this opportunity to comment on legislative proposals which would authorize depository institutions involvement in third party real estate brokerage. For several reasons which I will elaborate on during my testimony, it is the position of the NATIONAL ASSOCIATION OF REALTORS® that depository institutions should not be granted the authority to engage in third party real estate brokerage.

There are two issues I would like to address in my opening remarks. First, I would like to explain the functions performed by real estate brokers in the marketplace and second, I will dispel the misnomer that real estate brokers are in the "banking" business.

Real estate brokers perform three basic functions for the public: a marketing function to find buyers for sellers; a technical function to lead buyers and sellers through the intricacies of transferring interest in real property; and, an advisory function to assist buyers in determining the availability of funds to close the transaction.

It is this third function of assisting buyers in their efforts to secure mortgage financing that have led some in the banking industry to misunderstand that real estate brokers are now in the banking business. They contend that real estate brokerage firms which offer mortgage finance assistance to clients through either computerized programs such as the NATIONAL ASSOCIATION OF REALTORS® NATIONAL MORTGAGE ACCESS (RNMA) system or through mortgage companies have entered the banking business. It is indeed a misnomer to suggest that because the real estate industry has found a better way to market its product that this translates into real estate brokers being in the banking business.

REALTORS® using systems like RNMA are not banks or S & Ls. These computer systems do not require REALTORS® to assume any of the risk associated with the mortgage instrument selected by the buyer. Rather, the computerized sources of information on available mortgage instruments is like a public utility, it merely allows those participating in the service to tie into financing that is available. The actual risk associated with the extension of mortgage credit is shouldered by the lenders who ultimately provide the financing.

While it is true that some realty companies have opened mortgage company subsidiaries, it is also true that there are significant differences between mortgage banks on the one hand, and commercial banks and S & Ls on the other. A mortgage company is neither chartered by the federal government nor a state government and therefore does not enjoy the benefits of banks and savings and loans . When a mortgage company needs funds, it goes to the marketplace for them. It does not use FDIC or FSLIC insurance to attract capital. Further, mortgage banking companies do not have access to Federal Home Loan Bank Board advances or the FED discount window. Thus, to suggest that real estate brokers have entered the banking business is a fallacy.

While realty firms may own and operate mortgage companies, it is also true that bank holding companies have authority to own and operate mortgage banking companies, and many do. In this regard, we would bring to your attention a case decided by the Federal Reserve Board in March 1972. Boatmen's Bankshares, Inc., a bank holding company, applied to the FED for approval to acquire Williams, Kurrus Company, a mortgage banking firm. In approving the acquisition, the Board required Williams, Kurrus to terminate its third party real estate brokerage activities reasoning that: "Real estate brokerage is not an activity that the Board has determined to be so closely related to banking or mananging or controlling banks as to be a proper incident thereto." This reasoning appears to be predicated on the concept that to achieve safety and soundness, the regulatory system must keep banks in familiar territory. In Boatmen's, the Board went on to state that: nor has the applicant demonstrated that its activites in the real estate brokerage field are so closely related to banking or managing or controlling banks as to be a proper incident thereto.

In approving an application in September 1982 submitted by Bank America Corporation to engage in the activity of arranging equity financing through a subsidiary (BAMIRCO), the Board reaffirmed its position that third party real estate brokerage is not a permissible activity for bank holding companies explicitly stating that "because the particular expertise and analysis required for equity financing are not involved in general real estate brokerage, the Board's conclusion with respect to BAMIRCO's proposed activities does not represent a departure from the Board's position concerning the impermissibility of general real estate brokerage." These two cases clearly indicate that third party real estate brokerage are neither closely related to banking nor a proper incident thereto.

In light of the financial risk to the public, third party real estate brokerage firms, unlike most other commercial entities, are subject to a maze of state laws and regulations. For example, under state law, real estate brokers must meet various licensing and education standards and remain subject to public grievance procedures. Further, brokers must act in compliance with relevant state agency laws.

SAFETY AND SOUNDNESS

The reasons Congress enacted the Glass-Steagall and Bank Holding Company Acts are fundamental in a debate regarding financial institution deregulation, and in our view, remain valid today. The Glass-Steagall Act was enacted for the purpose of separating investment banking from commercial banking and the purpose of the Bank Holding Company Act is to require that any activities performed by a bank holding company be closely related to banking. Together, these two bodies of law effectually enforce a separation between banking and other kinds of financial and commercial activity and have served for over fifty years to maintain and promote the safety and soundness of financial institutions.

Now, in light of activities occurring in the marketplace provoked by various financial services companies, some members of Congress appear willing to abandon these laws and dismantle a system that has served our nation so well for the past fifty years. A system that has ably met this country's diverse needs including: The fostering of home ownership at levels unmatched by any other nation; access and availibility of credit throughout the country that has made small business the bulwark of our economy; and a secure, sound financial system which has regained the public confidence lost amid the disruption of the market in the 1920s.

In recognition of the fact that the failure of depository institutions is different than the failure of other business, Congress some fifty years ago enacted important legislation intended to promote a safe and sound banking system, reduce the potential for conflicts of interest, prevent the concentration of economic power in the hands of a few and avoid the extension of credit being tied to acceptance of other services. This rationale remains valid today as no one believes that human nature has changed, or that the growth of the expertise of regulators has been faster than the innovations and techniques of modern financial entrepeneurs. A review of the recent record supports this: The Penn Square failure; the collapse of the Butcher Banks in Tennessee; and the Chase Manhattan/Drysdale securities debacle. Further, the recent $8.4 billion IMF authorization was necessary because neither federal regulation nor bank management was sufficient to keep leading banks from over-extending in foreign debt.

The most recent threat to the safety and soundness of the system stems from money-market brokers whose brokered deposits seem to be ending up in failed institutions. This is another example of the failure of the regulatory structure to keep up with events in the market. Depository institutions are getting into trouble in this area too quickly for regulators to be aware of it, and the possibility exists that providing a warning signal could by itself push a marginal institution into failure.

We believe that the brokered deposit problem is symptomatic of the need for a broader and open-minded look at the issue of depository institution deregulation and its consequences for the safety and soundness of the banking system. Thus, we would urge Congress not to make decisions based solely on events occurring in the market, but rather, examine with scrutiny the level of the system's safety and soundness, as measured by whether our capital markets are orderly and the saving public is protected. We should not permit innovations in the marketplace to jeopardize depositor's savings as this is essential if we are to avoid a loss of public confidence and if the nation's pool of savings is to be tapped and converted to the long term credit on which our nation's businesses depend.

Let us not forget that current laws were enacted to keep depository institutions out of areas not closely related to banking because when depository institutions make bad decisions, the public and the economy suffer the consequences. The measure of whether the current system is working is not the number of banks nor their profitability; For Congress, the measure must be the level of the system's safety and soundness. Further, in response to those who reason that expanded powers including real estate brokerage, are necessary to promote the safety and soundness of depository institutions, we would remind them that third party brokerage is a cyclical business. Thus, during recessionary or high interest periods the ability to offer third party brokerage will do nothing to stabilize their earnings or help them maintain their market share.

SEPARATE AFFILIATE STRUCTURE

The NATIONAL ASSOCIATION OF REALTORS® strongly disagrees with those who argue that the separate affiliate structure alleviates anti-competitive and safety and soundness concerns. Although legal separation of parts of the holding company may be desirable to assist appropriate functional regulation and to help contain the elements of risk and conflicts of interest, it cannot prevent them. The combination of banking and real estate brokerage in one holding company makes it more likely that these products will be purchased in the same place, thereby greatly increasing the incentive and opportunity for tying arrangements. While it may be possible to cross-sell products without prima facie violations of anti-tying provisions (12 U.S.C.§ 1972 and § 12 U.S.C. 1464 (q)), it will be most difficult to avoid violating the spirit of the law.

The potential riskiness of non-banking activities is relevant to the public's perception of the safety and soundness of the depository institution itself. This is so because of the inevitable linking of a bank's regulation to that of its affiliates as the holding companies themselves, the securities markets and the general public look upon the holding company and its subsidiaries as one consolidated corporate entity.

This can be illustrated by the experiences of banks as real estate lenders in the mid-70s including the problems related to their REIT affiliations.

- In September 1974, American Bank and Trust of Orangeburg, South Carolina, was declared insolvent as a result of loan defaults by several large land developers.

- In February of 1976, the $400 million Hamilton National Bank failed as a result of the impact of the 1973-74 recession upon real estate loans acquired from the parent holding company and nonbank subsidiary (Hamilton Mortgage Company). Many of the loans were in default precluding the possibility of their sale. Additionally, since many of the loans were to the development projects and required the banks to lend additional funds, Hamilton National could only provide more funds to the projects or refuse to honor written commitments and face legal action.

- Although they apparently had no legal obligation to do so, Chase Manhattan eventually acquired $235 million in troubled loans from its affiliated REIT, of which more than $130 million was nonearning;

- First Wisconsin National Bank purchased nearly $15 million in loans from its affiliated REIT's and reimbursed the trust $5.5 million for losses in other loans;

- Continental Illinois purchased $61 million of loans from its namesake.

It is also possible that the public may confuse the name and identity of a risky affiliate with the bank, resulting in problems for the bank.

- In 1974, Beverly Hills Bank Corp., a one-bank holding company, found itself in trouble when a real estate developer defaulted on a substantial loan. As a result of the news accounts of the default, customers quickly withdrew 15 percent of deposits in the affiliated bank. The Federal Reserve intervened to halt the deposit run and the solvent bank was ultimately sold to Wells Fargo.

CROSS-SUBSIDY

Additionally, depository institutions argue that Section 23A of the Federal Reserve Act limits the ability of banks to make loans to their affiliates. Loans of an insured bank to an individual nonbank affiliate may not exceed 10 percent, and loans to all nonbank affiliates combined 20 percent of the bank's capital and surplus. The bankers statement that this limits the ability to loan money to affiliates is correct, however, the law explicitly authorizes such loans. Real estate brokerage is a labor intensive industry, not a capital intensive industry and therefore, allowing a captive brokerage firm to borrow up to 10 percent of a bank's capital and surplus would permit a captive brokerage firm to ride-out recessionary and high interest rate cycles in the economy, while their independent brokerage competitors would be forced to close down. Further, certain labor and administrative costs associated with the brokerage firm could be absorbed within the bank's overhead structure.

COMPETITIVE ADVANTAGES ENJOYED BY FEDERALLY INSURED AND FEDERALLY SUPPORTED INSTITUTIONS

Banks and thrifts serve many important public needs but do so with tremendous competitive advantages over other business entities. Thus, Congress must be cognizant of the fact that if a vast array of expanded powers is enacted for depository institutions, this will make depository institutions competitors, rather than resources for the commerce of this nation. Thus, we urge this Committee to carefully examine and consider what impact such deregulation will have on the long range availibility of credit to individuals and businesses of all sizes and kinds in all parts of the country. We cannot over-emphasize the fact that availability and access to credit are the heart and soul of our industry, and that depository institutions play a keyrole in providing the credit necessary to keep ours and other lines of commerce alive.

1. Federal Deposit Insurance

When a business needs capital, it must borrow these funds. Financial institutions borrow funds from depositors. These funds are in large part available because of federal deposit insurance. A cursory review of current advertisements for the Money Market Deposit Accounts and the proliferation of "non-bank banks" underscores the important advantgage of federal deposit insurance as a means of attracting depositors.

2. Favorable Tax Treatment

The tax treatment of federally chartered financial institutions also provides strong federal tax support that regular businesses do not enjoy. The bad debt reserve enables banks and thrifts institutions to deduct additions to bad debt reserves over and above actual loan losses. Banks can deduct interest on obligations incurred to purchase tax-exempt securities, something regular taxpayers cannot do. Banks also pay little or no tax on foreign activities. Other preferential tax treatment includes special rules for loss carryovers and carrybacks, exemptions from restriction on commodity tax straddles, and special rules for loan foreclosures. These tax adventages can help explain why the effective U.S. tax rate on U.S. income for commercial banks in 1981 was 2.3 percent while the retailing industry tax rate was 22.7 percent.

The nature of the relationship between a commercial enterprise and a financial institution could create anti-competitive situations. For example, service corporations are very effective tax management tools for their parent association that could lead to cross subsidies wrought by federal tax law. According to a "Special Management Bulletin" published by the U.S. League of Savings Associations on August 14, 1981, "The association's marginal tax rate is usually about 29%, whereas a service corporation's marginal tax rate is 46%. . . ."Mr. Chairman, the Bulletin then describes to thrifts how they can use this uneven tax treatment to their advantage. It says: "Service Corporations thus should undertake activities that will reduce parent expenses or generate income otherwise not available to the association." Further, this would seemingly allow service corporations to minimize profit margins to maximize the lower taxed parent institution's profit. This could create the situation where an independent small business could not compete with a service corporation that accepts lower profits due to the beneficial taxation of the parent institution, rather than any inherent efficiencies. There are no inherent advantages in claiming efficiencies when in reality these "efficiencies" are only another loophole in the tax law.

3. Access to Special Credit

Access to credit from federal regulatory agencies such as advances from the Federal Home Loan Banks and the Federal Reserve's discount window also give financial institutions an important tool not available to other businesses. These federally supported benefits for depository institutions are very important to assure this nation of a stable and secure system of depository institutions. However, these benefits put them in a special class. Any changes to make these institutions competitors rather than resources for the commerce of this nation must take into account these benefits and a likelihood that they would provide unequal and unfair competition.

In its testimony presented to this Committee on February 22, 1984, the American Bankers Association went to great length in attempting to explain that the aforementioned benefits do not provide depository institutions with any competitive advantages. However, on page 6 of that testimony, the ABA stated:

> "Recent history, including the well publicized problems of some banks with Real Estate Investment Trusts in the mid 1970s and the problems of the trift industry in 1981-82, indicates that federal deposit insurance programs and federal agencies as lenders of last resort are sufficient to maintain public confidence."

Further, in the Chase/Waage study submitted by the ABA, page 19, the authors state:

> "If a bank is properly managed and supervised, it ought to be able to handle any liquidity problems that might arise because of trouble in affiliates through access to the FED's discount window."

These two excerpts clearly indicate access to these federal benefits permits companies which might otherwise have failed to remain viable competitors, a benefit enjoyed by no other type of corporate entity.

TYING ARRANGEMENTS AND CONFLICTS OF INTEREST

The banking industry argues that tie-in sales are prohibited by current law and that no evidence exists that banks have been able to evade this law. The following cases brought to our attention by the Iowa State Association of REALTORS®, where state chartered institutions are permitted to broker real estate, highlight tie-in abuses and provide the foundation for our opposition to entry into real estate brokerage by federally insured and supported depository institutions:

- A broker in a western Iowa metropolitan board made several visits to southwest Iowa to assist one of his sales persons in listing a property. The client wanted to list, but informed the salesperson that a banker in the community was also licensed, and the banker had informed the prospective client that financing would not be available if they listed with someone other than him.

- A sales person with a firm in a western Iowa metropolitan board took a client into a Savings and Loan for a loan application. A vice president of the S & L called the buyer later in the day and said that before they could proceed on that particulart house, that their trust department had some properties to show them.

o A Waterloo REALTOR® had a house listed for several months. The sellers were several months behind in payments and could not come up with the money. While the listing was still in effect, the S & L who held the mortgage called on the sellers and said they were going to foreclose. However, they said they would give them an additional three months if they would list the property with them. The listing firm, not wanting to place the sellers in jeopardy, released them from the listing.

These abuses clearly indicate that the net commission from third party real estate brokerage provides depository institutions strong incentive to use mortgage credit to secure broker listings and sales. While these examples are indicative of violations of current anti-tying laws, we would suggest to the Committee that the same results could be accomplished through more subtle practices by depository institutions.

Further, when a depository institution as lender has a monetary incentive to make the loan over and above what it expects to collect in interest, it is put in a position where exercise of its independent judgment may be difficult. To authorize real estate brokerage affiliations may tempt the bank or savings and loans to make loans it does not consider safe and sound because of the extra inducement of aiding a business in which it has a direct financial interest. Where the institution's renumeration is a percentage of commissions, the institution has a direct as well as an indirect interest in making loans to customers of the affiliated brokerage irrespective of whether such loans represent a sound investment.

In addition, where, as is often the case in small communities, banks or savings and loans decision makers such as officers, directors, and loan committee members are also real estate brokers, it is even less likely that impartial judgments on the merits of each loan application could be made. If such individuals are participants in the institution's franchise operation, they have a personal incentive to approve loans to customers of the franchise; where they are in competition with the franchise, they may find it difficult to consider objectively loans to the customers of their competitors. The result, at best, will be decisions not entirely based on the objective criteria the institution has selected.

The potential for abuse is not limited to outright ownership. The NATIONAL ASSOCIATION OF REALTORS® has been writing the FHLBB about a federal savings and loan in Lincoln, Nebraska that, without seeking prior FHLBB approval, entered into a contractual arrangement with a real estate brokerage firm. More recently, we have read about another federally chartered savings and loan, Glendale Federal Savings and Loan Association's purchase of the southern California franchising license of Realty World. While Congress deliberates on this issue, de facto, federally chartered institutions are engaging in third party real estate brokerage, despite the fact that approximately two years ago, the Board withdrew proposed regulations which would have made third party brokerage a pre-approved activity for savings and loan service corporations.

We have attached for your review copies of local newspaper ads which clearly show that First Federal of Lincoln, Nebraska and MidAmerica Partners are affiliated. These ads also suggest that preferential lending rates are available for MidAmerica customers through First Federal of Lincoln.

UNDUE CONCENTRATION OF RESOURCES

While the banking industry appears to wear one face on the issue of expanded powers, there is great divisiveness amongst large and small banks on the issue of geographic deregulation. In response to Chairman Garn's question on February 22nd regarding regional interstate banking, Jack King, the witness for IBAA responded in the following manner:

> This is no good--concentration of assets and powers is no good--regional banks want their hunting grounds improved but want protection against New York bank predators.

This response clearly indicates that depository institutions want authority to compete in industries which they could dominate, but do not want to have to compete against each other. The NATIONAL ASSOCIATION OF REALTORS® is of the belief that allowing depository institutions to expand into new areas when coupled with the federal benefits they enjoy will permit banks to wield excessive power and drive out smaller independent competitors. In its testimony submitted to this Committee on February 22, 1984, the American Bankers Association notes that two of the markets which the proposed legislation would permit banks to enter, securities and insurance, are more concentrated than commercial banking. The American Bankers Association makes no such claim regarding the real estate brokerage industry.

While one may find some market areas around the country served by only one depository institution, to our knowledge, there exists no market area where you will find only one real estate brokerage company.

In conclusion, Mr. Chairman, we would reiterate the need for Congress to take a broad and open-minded look at the issue of additional depository institution deregulation. Both the banking industry and the public are still adjusting to the deregulation initiatives enacted in 1980 and 1982. Further, the record is unclear as to what, if any benefits the concept of a financial supermarket may bring to consumers. We leave you with one last thought, Mr. Chairman . . . the public can not afford banks to be the losers in commercial competitive markets.

Mr. Chairman, I thank the Committee for this opportunity to present the NATIONAL ASSOCIATION OF REALTORS® views and will be pleased to respond to your questions and comments.

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The interest rate is 9.95% (8.95% New Construction) fixed for the **First Two Years** of your mortgage. The rate then moves to 12.25% for three months and thereafter adjusts Quarterly . . . Payments are changed yearly based on the one year treasury index.

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You'll never pay more than 13.95% interest on your mortgage — no matter what happens to interest rates elsewhere! Because the 13.95% ceiling is fixed throughout the life of your mortgage, for a full 30 years.

If interest rates drop, your rate will **automatically** drop to a minimum of 9.95%. With your adjustable mortgage, you don't need to refinance to get the lower rate and pay all the costs!

Can I Afford to Buy?

It could very well be that you can't afford not to buy! Check the chart below. It's based on an average mortgage of $50,000, showing what the **minimum** and **maximum** principal and interest payments could be over the life of the mortgage.

- *** Simple interest is 9.95%. Annual percentage rate is 12.15% based on an increase in the interest rate to 12.25% after two years.**
- **** Simple interest is 8.95%. Annual percentage rate is 11.91% based on an increase in the interest rate to 12.25% after two years.**

Adjustable Rate Mortgage of $50,000 for 30 Years

	Interest Rate	Monthly Principal & Interest Payments
	9.95%	$436.94
	12.25%	$521.58
Ceiling***	13.95%	$586.27
Floor***	9.95%	$437.21

New Construction

	Interest Rate	Monthly Principal & Interest Payments
	8.95%	$400.52
	12.95%	$520.19
Ceiling***	13.95%	$584.71
Floor***	9.95%	$436.05

***On Balance after 2 Years at 8.95% (New Construction) or 9.95% (Existing Homes) and 3 Months at 12.25%.

INVEST IN YOUR FUTURE

(1746) Use Partners' new financing to enjoy the security of owning this two story home close to MED Center and VA Hospital. To obtain details call Dan Ryan 330-3333, 558-6833.

(1802) You will enjoy living where the air is fresh and the people are friendly. See this spotless 4 BDRM home with 3 bathrooms in Gretna. Ask about our 9.95 interest money. Call Joe Kusek 333-6829.

OVER 2000 FSF OF LIVING

(1833) Large 4 Bedroom, 3 bath home in Maple Village. Extra deep double car garage and over 70 cabinets in the kitchen and dining rooms. Priced in the Mid $80's. Call Pat Wingate and use our special financing. 330-3333 or at home 571-5601.

(1838) 3 Bedroom home, 1 car detached garage, central air all on ½ acre of ground, planted with fruit trees! All this and more, for details call Jean Curran 333-0630.

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You can buy a house today, regardless of your circumstances. We have financed clients with credit problems, little or no money for down payments, buyers with moderate incomes, singles, widows, divorcees, retirees and even clients who have filed for bankruptcy. As Financing experts, we have the ability and contacts to develop a financing program just for you using over 30 different methods of Real Estate Financing. If you want a house, not excuses, call us right now 330-3333.

JUST REMODELED

(1723) and ready to move into. Large 2 story home with 5 BR's and formal dining room, large lot and dbl. garage. All this for only $46,500. Call Helen Ehrenberg today at 391-7888, 330-3333.

SOUTH OMAHA STARTER

(1836) Nicely remodeled 2 BR home with expandable attic. Has newer carpet, updated wiring and plumbing. Call George Kryan 466-3041, 330-3333.

9960 DEVONSHIRE RD.

(1832) 4 bedroom, 4 bath ranch, 3,849 finished Sq. Ft. of luxurious living space. Beautiful view, call John Elfrein 391-6116 for private showing.

(1825) 2½ year old home in Better Than New Condition. Neutral colors, nice wallpapers. 3 BR's, 2 car garage. Across street from Park, school, pool. Only $53,500. For more information call Charlene Bolte at 333-0158 or 330-3333.

TRUE RANCH

(1834) on 2½ acres only 15 minutes from Westroads. 4 BR, 3 BA [illegible], main floor family room and utilities. Heavily treed and landscaped. $92,950. Barb Wolcott 333-3437, 330-3333.

2½ ACRES

(1827) Very nice remodeled farm house surrounded by trees. Close to town and priced to sell in the low, low $50's. Call Phil at 330-3333.

REDUCED & ASSUMABLE

(1818) Not many of these around any more especially if they have a main floor family room with a brick fireplace. Convenient to Immanuel and Vickers. To see call Martha Blizzard 493-1856, 330-3333.

NEW LISTING

(1837) 5617 S. 53 St. Immaculate home with 2 BR and 2 Baths. Cozy and comfortable. Large lot with lots of privacy. $38,900. Call Roselyn Sack 493-7897, 330-3333.

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OPEN DAILY 2-5

13502 Mercury St.

9.95 rate available VRM

OPEN 1-4

12304 Hascall

(1785) Hey! Wanna Steal A House! This one is a steal in the low $50's. 4 Plus Bedrooms, 2 Baths, and a 2 car garage. New carpet throughout. Slip over and see this one with Rosalyn Stick 493-7807 or 330-3333

CUSTOM BUILT

(1752) Unique floor plan. Offers 3 BR's, 3 baths, formal dining plus kitchen eating, microwave, pantry. Beautifully decorated in earthtones. Rec-room has wet bar, deck, walkout basement, patio. Call for details on this outstanding home at $74,900. Barb Wolcott 330-3333, 333-3437

LEAWOOD OAKS

(1724) Bellevue. New 2,300 sq. ft. executive home. Priced in mid $90's. Many extras in this 4 bedroom two story with nego. financing. Call Pat 733-6475

IT'S DIFFERENT

(1683) Close to interstate. 4 BDRM., 3 Bath ranch, 2 fireplaces. A floor plan that is different and nice. Walkout basement and storage under garage. Priced in $80's. Call John Effrein 391-6116, 330-3333

OPEN 2-5

ACREAGE

10130 N. 186 Ave.

(1678) Enjoy country living with picturesque setting 10 miles from Boys Town. 3 BDRMS., double garage and horses. See with Joe Kusek 333-6929 330-3333

OPEN 1-5

6312 Pratt

(1783) Convenient Location. Large FR on 1st floor artistically decorated. Ben Franklin stove in LR. Who said you can't have country living with all the benefits of city living. Call Marg Packard 330-3333, 493-1234

REDUCED $1,000

(1738) Cute 2 BDRM. Bungalow with newer carpeting. Cheery country kitchen. Close to park and golf course. Only $24,950. Call and ask for Martha Blizard 493-1855, 330-3333

LOAN ASSUMPTION

(1778) Beautiful custom 3 BDRM home in Millard is finally on the market. It has everything you are looking for Plus a low interest assumable loan. Joanne Kotrous 330-3333

AVOID THE RAT RACE

(1768) Small town living just minutes from Omaha. Completely remodeled 4 BDRM., 2 car gar. Large corner lot. Upper $50's. Call and ask for Chuck Bode 391-0656, 330-3333

CENTRALLY LOCATED TWO-STORY

(1747) Beautiful fenced back yard with mature trees. Great buy in the mid $50's. Call Harold Jones 330-3333, 331-9195

OPEN 2-5

4963 Virginia St.

(1749) Close to School! Kids can walk to elementary, Jr. High and high schools from this better-than-new home. 5 yr. old SPET in excellent condition in Sarpy County. For more info call Charlene Boffe 333-8158, 330-3333

OPEN 2-4

5414 Jaynes

(1788) Three Bedroom Brick. Newly painted inside and out. Breezeway connecting garage. Large fenced back yard. Security system. Jean Curnyn 333-0630, 330-3333

SUPER LOAN ASSUMPTION

(1582) Priced in $40's. 4 BR. multi-level with over 1600 Sq. Ft., 2 car garage, close to schools and hospital. Call Marj Packard 493-1234, 330-3333

ON CUL-DE-SAC IN PARKSIDE

(1636) California multi-level. Master BDRM. suite separate from others. Ideal for family with teenagers. 4 BDRMS., formal dining, main floor dining. Walk to Millard schools, shopping. Excellent financing. Carol Elrod 330-3860, 330-3333

OPEN 1-4

2312 N. 143rd St.

(1744) LOAN IS ASSUMABLE. 9½% assumable FHA loan. 3 BDRM. 4-plus yr. old split-entry. Finished rec room and 2 car garage. Patio and fenced yard. Call John Effrein 391-6116

OPEN 2-4

10604 Yort Circle

(1761) 4 BDRM. ranch in Sunnyslope. Main floor family room with fireplace, many mature trees, on quiet cul-de-sac. See with Martha Blizard 493-1855, 330-3333

MAPLEVIEW

(1765) Cathedral ceilings in this 4 BDRM., 2 bath home. Formal dining, large kitchen w/new appliances and walkout to covered patio. Fireplace in FR. $57,900. Barb Wolcott 333-3437, 330-3333.

TRANSFERRED OWNER

(1774) Must Leave this 1 yr. old 3 BDRM., 3 baths, 1800 Sq. Ft. Attractive financing. Call Chuck Bode 391-0656.

QUIET BENSON NEIGHBORHOOD

(1780) Nicely finished ranch with level yard, central air, new furnace. Recently sided and priced competitively in upper $30's. Call Stan Jones 330-3333.

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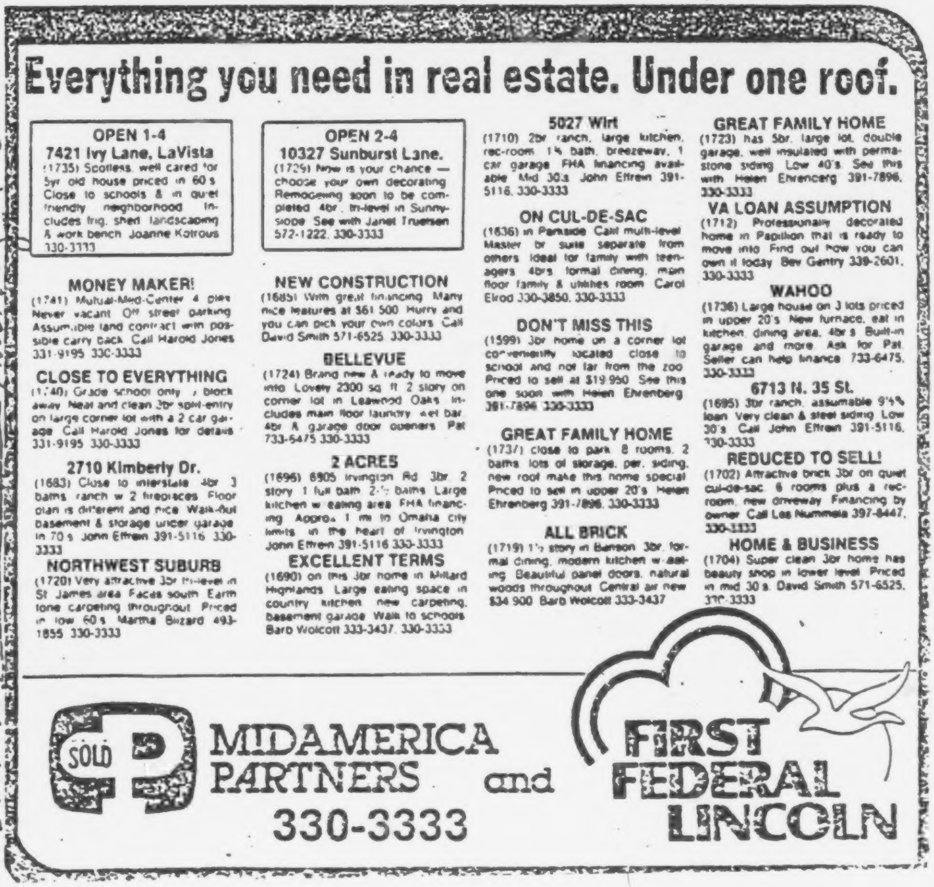

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OPEN 1-4
7421 Ivy Lane, LaVista
(1735) Spotless, well cared for 5yr old house priced in 60's. Close to schools & in quiet friendly neighborhood. Includes frig, shed, landscaping & work bench. Joanne Kotrous 330-3333

OPEN 2-4
10327 Sunburst Lane.
(1729) Now is your chance — choose your own decorating. Remodeling soon to be completed 4br. tri-level in Sunnyslope. See with Janet Truelsen 572-1222, 330-3333

MONEY MAKER!
(1741) Mutual-Med-Center 4 plex. Never vacant. Off street parking. Assumable land contract with possible carry back. Call Harold Jones 331-9195 330-3333

CLOSE TO EVERYTHING
(1740) Grade school only ½ block away. Neat and clean 3br split-entry on large corner lot with a 2 car garage. Call Harold Jones for details 331-9195 330-3333

2710 Kimberly Dr.
(1683) Close to interstate. 4br. 3 baths ranch w 2 fireplaces. Floor plan is different and nice. Walk-out basement & storage under garage. In 70's. John Effrein 391-5116. 330-3333

NORTHWEST SUBURB
(1720) Very attractive 3br tri-level in St James area. Faces south. Earth tone carpeting throughout. Priced in low 60's. Martha Bizzard 493-1855 330-3333

NEW CONSTRUCTION
(1685) With great financing. Many nice features at $61,500. Hurry and you can pick your own colors. Call David Smith 571-6525 330-3333

BELLEVUE
(1724) Brand new & ready to move into. Lovely 2300 sq. ft. 2 story on corner lot in Leawood Oaks. Includes main floor laundry, wet bar, 4br & garage door openers. Pat 733-6475 330-3333

2 ACRES
(1696) 6905 Irvington Rd. 3br. 2 story. 1 full bath, 2-½ baths. Large kitchen w eating area. FHA financing. Approx. 1 mi to Omaha city limits, in the heart of Irvington. John Effrein 391-5116 330-3333

EXCELLENT TERMS
(1690) on this 3br home in Millard Highlands. Large eating space in country kitchen, new carpeting, basement garage. Walk to schools. Barb Wolcott 333-3437, 330-3333

5027 Wirt
(1710) 2br ranch, large kitchen, rec-room, 1¼ bath, breezeway, 1 car garage. FHA financing available. Mid 30's. John Effrein 391-5116, 330-3333

ON CUL-DE-SAC
(1636) in Parkside. Cal multi-level. Master br suite separate from others. Ideal for family with teenagers. 4br's, formal dining, main floor family & utilities room. Carol Elrod 330-3850, 330-3333

DON'T MISS THIS
(1599) 3br home on a corner lot conveniently located close to school and not far from the zoo. Priced to sell at $19,950. See this one soon with Helen Ehrenberg 391-7896 330-3333

GREAT FAMILY HOME
(1737) close to park. 8 rooms, 2 baths, lots of storage, per. siding, new roof make this home special. Priced to sell in upper 20's. Helen Ehrenberg 391-7896, 330-3333

ALL BRICK
(1719) 1½ story in Benson. 3br, formal dining, modern kitchen w eating. Beautiful panel doors, natural woods throughout. Central air new. $34,900. Barb Wolcott 333-3437

GREAT FAMILY HOME
(1723) has 5br, large lot, double garage, well insulated with perma-stone siding. Low 40's. See this with Helen Ehrenberg 391-7896, 330-3333

VA LOAN ASSUMPTION
(1712) Professionally decorated home in Papillion that is ready to move into. Find out how you can own it today. Bev Gentry 339-2601, 330-3333

WAHOO
(1736) Large house on 3 lots priced in upper 20's. New furnace, eat in kitchen, dining area, 4br's. Built-in garage and more. Ask for Pat. Seller can help finance. 733-6475, 330-3333

6713 N. 35 St.
(1695) 3br ranch, assumable 9¼% loan. Very clean & steel siding. Low 30's. Call John Effrein 391-5116, 330-3333

REDUCED TO SELL!
(1702) Attractive brick 3br on quiet cul-de-sac. 6 rooms plus a rec-room, new driveway. Financing by owner. Call Les Nummela 397-8447, 330-3333

HOME & BUSINESS
(1704) Super clean 3br home has beauty shop in lower level. Priced in mid 30's. David Smith 571-6525, 330-3333

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Sincerely,

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CHARLES H. THORNE
PRESIDENT

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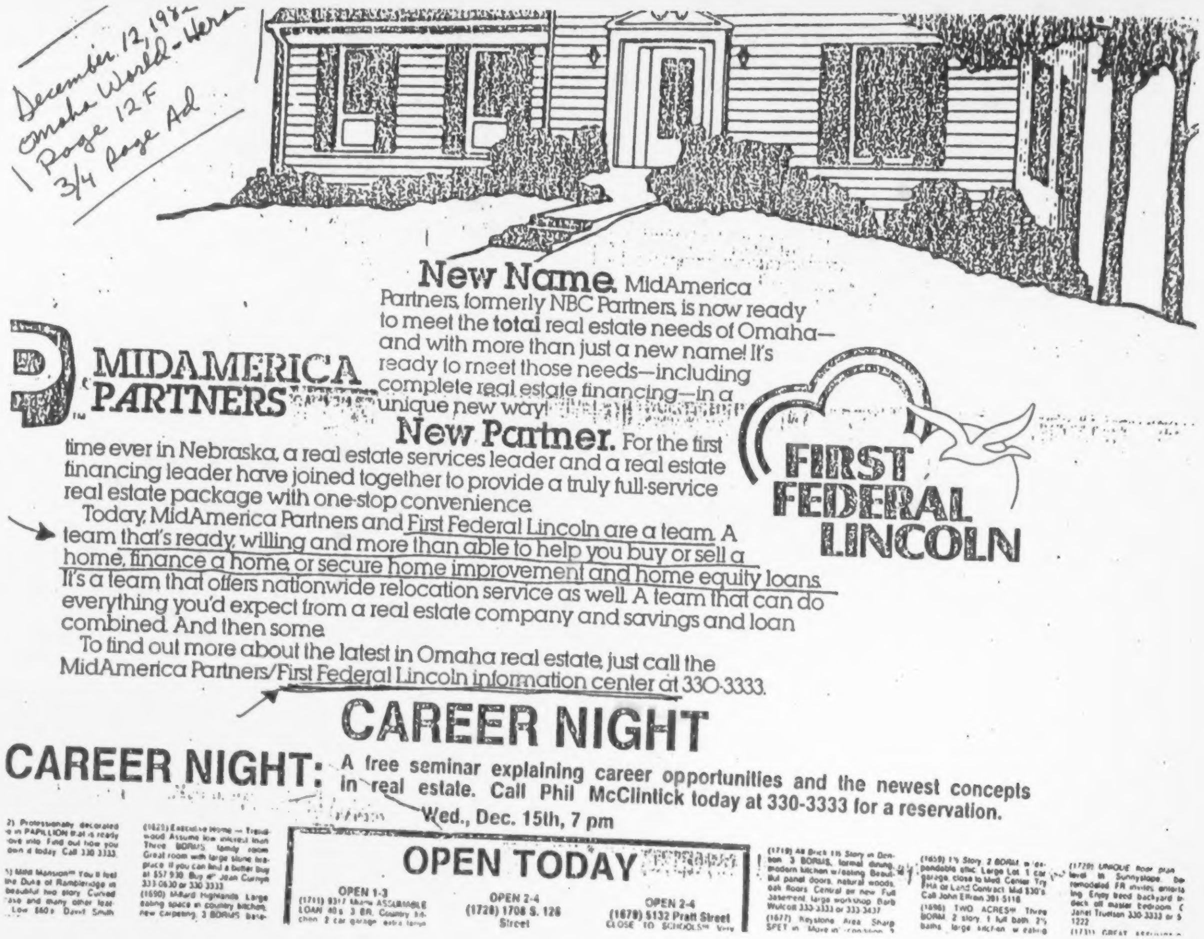

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(1679) 5132 Pratt Street

Senator RIEGLE. Mr. Chairman, before you call the next witness, may I just say we in Michigan are very proud to have Mr. Treadwell as the president of the National Association of Realtors and I just want to say that was an outstanding statement and we appreciate having it.

Mr. TREADWELL. Thank you very much, Senator.

The CHAIRMAN. Mr. Teutsch.

STATEMENT OF JOHN M. TEUTSCH, JR., CHAIRMAN, LEGISLATIVE COMMITTEE, MORTGAGE BANKERS ASSOCIATION; PRESIDENT AND CHIEF EXECUTIVE OFFICER, RAINIER FINANCIAL SERVICES, SEATTLE, WASH.

Mr. TEUTSCH. Mr. Chairman and members of the committee, my name is John Teutsch. I am president of Rainier Financial Services Co., located in Seattle, Wash. I serve as chairman of the legislative committee of the Mortgage Bankers Association of America.

We appreciate the opportunity to appear before you today to discuss the bills S. 1609, S. 2134, and S. 2181. These bills involve the continuing evolution of the financial services industry and in that sense we generally support their thrust. We will focus, however, on those provisions affecting real estate finance.

A substantial portion of MBA's membership is composed of commercial banking and thrift institutions and of subsidiaries of these depositories and their holding companies. In addition, many of our members are the affiliates of securities, retail, insurance, and other commercial corporations that compete with depository institutions. The effects, both favorable and adverse, of this growing competition on real estate financing have been particularly visible to MBA.

MBA SUPPORTS INCREASED COMPETITION AND DIVERSIFICATION

MBA has consistently supported increased competition and diversification of financial services of depository institutions. These bills recognize, however, that the range of direct competitors to depository institutions has broadened dramatically to include financial services firms in a variety of businesses. The ability of these unregulated financial services firms to respond innovatively and rapidly to market changes has blurred the distinction between their own and traditional banking services. The types of services provided by these financial competitors have not only caught up with those of depository institutions, but in many instances have surpassed them. It is now imperative that depository institutions be able to expand their products and services in order to maintain and enhance their competitive position as financial intermediaries.

In this regard, MBA supports the general thrust of S. 2181 and its predecessor, S. 1609. The intent of these bills is to bring about competitive equity in the provision of financial services by the banking and thrift industries without affecting the fundamental structure and nature of the depository institutions themselves. Thus, financial services are to be expanded through comparable holding company affiliates, while the diverse asset and liability powers of banks and thrifts themselves remain unaffected.

MBA generally concurs that the holding company structure can be an appropriate means by which depository institutions may expand the products and services they offer to the public. We recognize and support the role of the holding company in insulating the depository institution from the potential risks associated with nonbanking activities. MBA is concerned, however, that S. 2181 does not fully address the ability of the thrift industry to reorganize easily into the holding company structure. The bill, as written, would deny or delay the access of the greater portion of the thrift industry to the expanded activities by failing to recognize that most S&L's are structured as mutuals. Thus, mutual associations would not only have to form holding companies, but would first have to convert to stock form. A further significant consideration is that many State laws prohibit stock associations.

In theory, all banks, because of their corporate structure, could form holding companies and begin to engage in new activities in as few as 90 days. At the same time, however, over 60 percent of all thrifts would be hard pressed to form holding companies and begin their new activities in less than 1 or 2 years.

MBA has long supported the expansion of bank holding companies into real estate investment, development, and brokerage activities.

While real estate investment is not specifically defined, we presume that it refers to equity positions and would include syndication, equity financing, joint ventures, and the acquisition of property for development, rehabilitation, leasing, and resale. Being closely related to the real estate financing function of thrifts, these activities have long been permissible and important activities for service corporations and S&L holding company subsidiaries. Such activities are integral services of the real estate financing industry and the ability of mortgage companies to offer a complete package of such services and financing techniques is becoming increasingly important to developers, owners, and investors.

We do not support the bill's provision to limit a holding company's real estate investment and development activities to 5 percent of the holding company's primary capital. This limit appears somewhat arbitrary and inappropriate and we have serious doubts about whether there is a need for this limit at all.

The primary capital limitation is undefined, so it is difficult to assess its effects. Regardless of the problems in defining the application of the capital limitation, however, MBA opposes this provision altogether because it is unreasonably restrictive.

The thrift industry is already much more involved in real estate investment and development activities than this provision allows, because thrifts may invest directly up to 3 percent of their assets in service corporations engaged in these activities. Consequently, this provision effectively results in an unwarranted reduction in the thrift industry's participation in these activities.

More to the point, however, our opposition to the capital limitation rests on the simple fact that no other existing or proposed holding company activity, regardless of its potential risk, is subject to any investment limitation. Consequently, MBA believes that this is protectionism and will restrict competition in real estate investment and development activities.

MBA supports the concept of providing an incentive to financial institutions to be active mortgage lenders in return for less regulatory restrictions on the activities of the parent holding company. That incentive already exists in the Internal Revenue Code, which allows a bad debt deduction to thrifts that devote a percentage of their portfolios to qualified mortgage investments. We urge that the assets test should be made an option for all financial institution holding companies, including a unitary bank holding company.

PROPOSED ASSETS TEST SHOULD INCLUDE AN ORIGINATIONS TEST

Second, MBA believes that, if the purpose of the proposed assets test is to insure an institutional source of residential mortgage credit, then the test should reflect the current market reality that mortgage lenders do not also have to be investors in mortgages in order to supply mortgage credit to borrowers. We strongly suggest that the proposed assets test be amended to include an originations test, which would recognize the reality that institutions can supply large amounts of residential mortgage credit while investing the majority of their capital in other assets.

MBA supports the provisions contained in S. 1609 and S. 2181 authorizing holding companies to sell or underwrite insurance. There is a natural relationship between extensions of credit and insurance. This is not to say that a financial institution that offers credit has any right to dictate that its own insurance should also be purchased. However, financial institutions should be able to compete with other enterprises on an equal footing without an overlay of restrictive requirements. Presently, applicable law and regulations already prohibit tie-in arrangements, as well as allow consumers to cancel insurance contracts within a specified time period. MBA believes that the present protections already provide sufficient safeguards.

MBA supports the authorization in both S. 2181 and S. 2134 allowing depository institutions securities affiliates to underwrite and deal in private issues of mortgage-backed securities. Currently, banks are authorized to issue both private and Government-sponsored mortgage-backed securities and they should retain this authority even if they establish a securities affiliate. However, an affiliate would be appropriate to underwrite or deal in private or Government-sponsored mortgage-backed securities.

MBA supports title VII of S. 2181, which would preempt State usury laws governing consumer loans and extend the current preemption of State usury laws governing business and agricultural loans. Today, the market for credit is nationwide and rather than serving as protections for unsophisticated consumers, State usury laws serve as serious impediments to the free interstate flow of commerce. The true determinant of interest rates—the interplay of the forces of supply and demand in the market—should set interest rates, so that credit is available to consumers who can then choose whether or not they wish to pay the market rate for credit.

Thank you very much for this opportunity to testify. I would be happy to answer any questions you might have.

[Complete statement follows:]

1125 Fifteenth Street, N.W.
Washington, D.C. 20005
202-861-6500

Mortgage Bankers Association of America

STATEMENT OF

JOHN M. TEUTSCH, JR., CMB
PRESIDENT
RAINIER FINANCIAL SERVICES
SEATTLE, WASHINGTON

on behalf

of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

Hearings on
S 1609 - Financial Institutions Deregulation Act
S 2134 - Depository Institutions Holding Company Act Amendments of 1983
S 2181 - Financial Services Competitive Equity Act

March 7, 1984

Mr. Chairman and Members of the Committee, my name is John Teutsch. I am President of Rainier Financial Services Company, located in Seattle, Washington. I also serve as Chairman of the Legislative Committee of the Mortgage Bankers Association of America. MBA is the trade association of the Nation's mortgage banking and real estate finance industries. Accompanying me today are Burton C. Wood, MBA's Legislative Counsel, and Sharon M. Canavan, MBA's Associate Legislative Counsel.

We appreciate the opportunity to appear before you today to discuss the bills S 1609, the "Financial Institutions Deregulation Act," S 2134, the "Depository Institutions Holding Company Act Amendments of 1983," and S 2181, the "Financial Services Competitive Equity Act." These bills involve the continuing evolution of the financial services industry and in that sense we generally support the thrust of the purpose of the bills. We focus our statement, however, on those provisions affecting real estate finance.

A substantial portion of MBA's membership is composed of commercial banking and thrift institutions and of subsidiaries of these depositories and their holding companies. In

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

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- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500 addition, many of our members are the affiliates of securities, retail, insurance, and other commercial corporations that compete with depository institutions. The effects, both favorable and adverse, of this growing competition on real estate financing have been particularly visible to MBA.

MBA has consistently supported increased competition and diversification of financial services of depository institutions. These bills recognize, however, that the range of direct competitors to depository institutions has broadened dramatically to include financial services firms in a variety of businesses. The ability of these unregulated financial services firms to respond innovatively and rapidly to market changes has blurred the distinction between their own and traditional banking services. The types of services provided by these financial competitors have not only caught up with those of depository institutions, but in many instances have surpassed them. It is now imperative that depository institutions be able to expand their products and services in order to maintain and enhance their competitive position as financial intermediaries.

In this regard, MBA supports the general thrust of S 2181 and its predecessor, S 1609. The intent of these bills is to bring about competitive equity in the provision of financial services by the banking and thrift industries without affecting the fundamental structure and nature of the depository institutions themselves. Thus, financial services are to be expanded through comparable holding company affiliates, while the diverse asset and liability powers of banks and thrifts themselves remain unaffected. MBA is concerned, however, that a number of the bill's provisions are inconsistent with these aims and may, in fact, perpetuate inequities rather than eliminate them.

These provisions result, in our opinion, from a failure to recognize the diversity in bank and thrift structures, in particular, that the majority of thrifts are mutually held. In addition to structural and ownership differences between banks and thrifts, the varying experiences, histories, and philosophies of these two industries are factors that may not have received due recognition. The result, in some instances, is that the bills offer simple provisions for complex issues and complex provisions for simple issues.

FINANCIAL SERVICES ACTIVITIES

Holding Company Reorganization of Depository Institutions

MBA generally concurs that the holding company (HC) structure can be an appropriate means by which depository institutions may expand the products and services they offer to the public. We recognize and support the role of the HC in insulating the depository institution from the potential risks associated with nonbanking activities. This provides a mechanism that allows the use of insured deposits to be limited to controlled and prudent investments consistent with the safety and soundness of the bank or thrift, while allowing the HC enterprise to engage in less restrictive ventures. This structure thus tends to protect the public's deposits and the Federal insurance funds behind those deposits.

MBA is concerned, however, that S 2181 does not fully address the ability of the thrift industry, for the most part, to reorganize easily into the HC structure. The bill, as written, would deny or delay the access of nearly 60 percent of the thrift industry to the expanded activities simply because of the historical difference in the structure of thrifts.

The legislation first requires that activities may be conducted only through HCs, and, second, limits the nonbanking activities of both bank and thrift service corporations. Consequently, any bank or S&L wishing to engage in such activities must form a HC. To this end the bill includes provisions to facilitate and reduce the expense of a HC reorganization.

Even with these provisions, however, the bill, although it intends to enhance competitive equity for both banking and thrift organizations, immediately excludes almost 77 percent of the thrift industry by failing to deal realistically with the mutual structure. At the end of 1983, 1,424, or 91.7 percent, of all Federal associations were mutual and only 129, or 8.3 percent were stock, and 59 percent of all Federal Savings and Loan Insurance Corporation (FSLIC)-insured associations were mutual. Conversions have increased during 1983, but the mutual form of ownership still predominates.

Thus, in order to take advantage of the range of new activities offered by the bill, these associations would not only have to form HCs, but would first have to convert to stock form. The bill's provision to make HC reorganization less costly and time consuming simply does not address the problems involved in a stock conversion.

Such a conversion is expensive and time consuming in the best of circumstances and it can be easily complicated by many factors. A significant consideration is that many state laws prohibit stock associations. Thus, in such states, a state-chartered association either cannot convert until state laws are changed or must convert to a Federal charter. Yet many of these thrifts would be unable to meet the more stringent requirements for a Federal stock charter without incurring considerably more expense and delay. Our point here is that, although financial services competitive equity should exist at the HC level, it may well be undermined before it gets to that level.

In theory, all banks, because of their corporate structure, could form HCs and begin to engage in new activities in as few as ninety days. At the same time, however, nearly 60 percent of all thrifts would be hard-pressed to form HCs and begin their new activities in less than one or two years. In many markets that time difference could be crucial.

With respect to this fundamental inequity, MBA respectfully suggests that a workable alternative should be provided for mutual thrifts during the period following the bill's enactment. For example, a mutual association, upon passing a board resolution to convert, might be allowed to engage temporarily in a new activity through a service corporation, with a time limit as to when the HC must be in place and the activity transferred from the service corporation to the HC.

The bill does consider that mutual thrifts may not form HCs and, consequently, permits mutuals to continue to operate service corporations under existing laws. Nevertheless. it precludes these thrifts from engaging in any new activities permitted by the bill until conversion takes place and an HC is formed.

The bill would not allow existing service corporation activities of mutuals to be compatible and competitive with some of the less risky activities newly allowed for bank HCs (BHC) and savings & loan HCs (S&LHC). Service corporations' future activities would remain limited to those that were permissible as of July 1, 1983. We believe that this unnecessarily impedes the ability of mutuals to respond to market developments and precludes much of the very flexibility that this initiative is intended to foster.

For example, real estate brokerage will be increasingly important to thrifts' lending activities. Service corporations currently may engage in real estate brokerage but only for limited purposes and not for third parties as the bill permits for subsidiaries of BHCs and S&LHCs. Current brokerage activities of mutually owned service corporations should be expanded to include services for third parties. We urge the legislation be amended accordingly.

Expanded Powers for Depository Institution Holding Companies (DIHC)

Real Estate Activities. The bill allows BHCs and S&LHCs to engage in real estate investment, development, and brokerage. MBA has long supported the expansion of BHCs into these activities. With respect to this section, we wish to address the specific activities permitted and the proposed limit on development and investment activities.

Definition of Real Estate Activities. First, the section-by-section analysis of the bill states that property management is to be considered a permissible real estate brokerage activity and, therefore, not subject to the primary capital limitation imposed on investment and development. The language of s 2181 itself, however, is not so clear. Rather, the bill apparently includes property management in its definition of real estate investment and development. We believe that any ambiguity could be eliminated by simply specifying property management as a separate activity in Section 104(d)(iii).

"Real estate investment" is not further defined, but, within the context of the bill, we presume that it refers to equity positions and would include syndication, equity financing, joint ventures, and the acquisition of property for development, rehabilitation, leasing, and resale. Being closely related to the real estate financing function of thrifts, these activities have long been permissible and important activities for service corporations and S&LHC subsidiaries. Such activities are integral services of the real estate financing industry and the ability of mortgage companies to offer a complete package of such services and financing techniques is becoming increasingly important to developers, owners, and investors. Consequently, MBA fully supports the addition of these activities to those permissible for all financial institution HCs. We believe the term "real estate investment" should be more precisely defined and examples of what constitutes real estate investment should be provided.

Limit on Activities. We do not, however, support, the bill's provision to limit a HC's real estate investment and development activities to 5 percent of the HC's primary capital. This limit appears somewhat arbitrary and inappropriate and we have serious doubts about whether there is a need for this limit at all.

The primary capital limitation is undefined so it is difficult to assess its effects Nevertheless, a few conjectures as to its meaning reveal that this measure is likely to result in a prohibitively small amount of funds for engaging in these real estate activities.

If we estimate that an HC's primary capital, based on paid-in and unimpaired capital and surplus, is between 5 percent and 10 percent of its assets, then 5 percent of this capital represents the maximum investment of one quarter of 1 percent and one half of 1 percent, respectively, of the HC's total assets. Even if the definition of primary capital were such that it would equal 20 percent of assets, the permissible investment still would not exceed 1 percent of the HC's assets.

Second, and more important, it is impossible to determine from the language of the bill what exactly it is that is subject to the capital limitation. The bill states only that "engaging" in these activities is subject to the limit. Thus, the limit could be interpreted as applicable to either the HC's direct capital investment in a real estate subsidiary or to the amount of funding provided for real estate projects.

For example, if 5 percent of a HC's primary capital is $5 million, then the HC may have $5 million invested in the stock of a real estate subsidiary, while the subsidiary itself may have $20 million invested in real estate projects. If the bill's limit applies to capital investment, the HC complies with the law; if the limit applies to outstanding funding, the HC does not comply. If this latter case reflects the intent of the bill, then few HCs could engage in real estate investment and development activities.

There are many other possible examples that raise further questions about the limit. The HC may provide initial capitalization within the limit, while a cumulative capital investment resulting from internal growth of the subsidiary could exceed the limit. Or the HC may use an existing mortgage subsidiary to conduct these real estate activities, in which its existing investment exceeds the 5 percent of primary capital limit.

Regardless of these problems in defining the application of the capital limitation, MBA opposes this provision altogether because it is unreasonably restrictive and is, in fact, an anomaly within this legislation.

The thrift industry is already much more involved in real estate investment and development activities than this provision allows, because thrifts may invest directly up to 3 percent of their assets in service corporations engaged in these activities. Consequently, this provision effectively results in an unwarranted reduction in the thrift industry's participation in these activities. It is unfair to thrifts because it denies them their longstanding experience and expertise in real estate development, syndication, and investment activities. We fail to see the rationale for reducing thrift involvement in these activities simply because they will be conducted through the HC rather than through the service corporation.

Another possible consequence of this situation would in fact place BHCs and some thrifts at a competitive disadvantage, despite equal application of the capital limit to both BHCs and S&LHCs. S 2181 provides for three instances in which thrifts' broader real estate activities could continue through service corporations whose parents are either qualified thrift lenders, grandfathered, or mutuals. Moreover, this competitive disadvantage would also extend to thrifts that either were not established on July 1, 1983, or did not have such service corporations as of that date. Thus, we believe that the HC limitation on these real estate activities could foster an untenable situation that actually will perpetuate competitive inequities.

More to the point, however, our opposition to the capital limitation rests on the simple fact that no other existing or proposed HC activity, regardless of its potential risk, is subject to any investment limitation. Consequently, MBA believes that this is protectionism and will restrict competition in real estate investment and development activities. Thus, this provision runs contrary to the aims that this legislation seeks to accomplish and should be eliminated altogether.

If, however, the committee continues to believe there is a need for some restriction, then MBA proposes that a more realistic limit based on assets would be appropriate. Such a limit should be increased periodically until it is eliminated entirely.

Thrift Assets Test

MBA supports the concept of providing an incentive to financial institutions to be active mortgage lenders in return for less regulatory restrictions on the activities of the parent HC. However, that incentive already exists in the Internal Revenue Code, which allows a bad debt deduction to thrifts that devote 82 percent of their portfolios to qualified mortgage investments (72 percent for savings banks). With respect to the specific assets test set forth in Section 108 of S 2181, we urge that the section be amended in two ways.

First, the section should be made an option for all financial institution HCs. Thus, any unitary BHC whose bank meets whatever mortgage asset (or as we urge below, mortgage lending) test contained in the statute should be freed from the regulatory restrictions placed on other financial institution HCs.

Second, MBA believes that, if the purpose of the proposed assets test is to ensure an institutional source of residential mortgage credit, then the means of ensuring that source should reflect the current market reality that mortgage lenders do not also have to be investors in mortgages in order to supply mortgage credit to borrowers. As the secondary mortgage market experience of the past several years amply demonstrates, mortgage origination and mortgage investment are increasingly becoming separate and distinct functions not necessarily performed by a single institution. We strongly suggest that the proposed assets test be amended to include an originations test, which would recognize the reality that institutions can supply large amounts of residential mortgage credit while investing the majority of their capital in other assets. We believe that the trade-off of relaxed HC regulation should be in return for assured supplies of residential mortgage credit rather than blindly assuming that an assets test will ensure that the institution is an active supplier of mortgage credit.

Insurance Activities

MBA supports the provisions contained in S 1609 and S 2181 authorizing HCs to sell or underwrite insurance. There is a natural relationship between extensions of credit and insurance. This is not to say that a financial institution that offers credit has any right to dictate that its own insurance should also be purchased. However, financial institutions should be able to compete with other enterprises on an equal footing without an overlay of restrictive requirements.

MBA opposes the restrictive language in S 1609 and S 2181, which places additional restraints on insurance sales to prevent "tie-ins." Presently, applicable law and regulations already prohibit tie-in arrangements, as well as allow consumers to cancel insurance contracts within a specified time period. MBA believes that the present protections already provide sufficient safeguards.

Insurance is a highly competitive field that will only become more so with the increased competition financial institutions' activities will provide. The ability to complete a banking and insurance transaction in a single place offers the consumer increased convenience. Nonetheless, the consumer who wishes to purchase the least expensive, most comprehensive insurance policy will shop around and compare prices and products before deciding on a contract.

It is unfair to burden financial institutions with requirements that other insurance offerers do not have to meet, simply because the financial institution can offer convenience as well as an attractive product. This is particularly true because anti-tying protections to safeguard consumer interests already exist.

Depository Institution Securities Affiliates

S 1609, S 2134, and S 2181 mandate that financial institutions may engage in permissible securities activities only through a depository institution securities affiliate (DISA). The

Federal Reserve Board is empowered to list those activities that may be engaged in only by a DISA, after a one year period allowed to form the DISA. At that time, permissible securities activities of the bank must be transferred to the DISA.

MBA supports the authorization in both S 2181 and S 2134 allowing depository institutions to underwrite and deal in private issues of mortgage-backed securities (MBSs). Currently, banks are authorized to issue both private and government-sponsored MBSs. MBA supports an exception that would allow a depository insitution to continue to issue MBSs whether or not the depository insitution forms a securities affiliate. However, a DISA should be formed to underwrite or deal in private or government-sponsored MBSs.

Consumer Banks

MBA supports the permissibility in S 2181 of residential real estate finance activities by consumer banks. This authority specifically permits investing in MBSs. MBA presumes that the charter authority of a consumer bank is identical to that of a traditional commercial bank. Therefore, consumer banks would be authorized to issue MBSs as well as invest in them. This access to the secondary market is essential to the process of residential mortgage origination and should not be restricted.

Regulatory Control

MBA is uncomfortable with the provision that authorizes the Federal Reserve Board to determine permissible activities that are of a financial nature or that are closely related to banking for both BHCs and S&LHCs. The bill authorizes the FHLBB to act only to prohibit or otherwise limit such an approved activity for S&LHCs.

In our opinion, this provision runs counter to the intent of this legislation to promote competitive equity among the financial services of both BHCs and S&LHCs. The Federal Home Loan Bank Board's (FHLBB) effective 'veto' power defeats this purpose by creating the potential for S&LHCs to be prohibited from engaging in activities permissible for BHCs.

We would not be any more comfortable if the Federal Reserve Board's decisions were to be made universally applicable to BHCs and S&LHCs alike by eliminating the FHLBB's 'veto'. Rather, MBA encourages an arrangement by which the Federal Reserve Board and the FHLBB would jointly determine permissible financial services for all HCs.

USURY PREEMPTION

MBA supports Title VII of S 2181, which would preempt state usury laws governing consumer loans and extend the current preemption of state usury laws governing business and agricultural loans.

Title VII recognizes that the Nation is no longer a collection of independent, localized credit markets, which may or may not be affected by national developments. Today, the market for credit is nationwide and rather than serving as protections for unsophisticated consumers, state usury laws serve as serious impediments to the free, interstate flow of commerce.

As we have said in the past, usury limits do not set interest rates, they simply restrict the flow of credit when market rates rise above the usury limit. The true determinant of interest rates—the interplay of the forces of supply and demand in the market—should set interest rates, so that credit is available to consumers who can then choose whether or not they wish to pay the market rate for credit.

Mortgage bankers are not in the consumer lending business except for second mortgage and home improvement loans. Purchase programs for such loans by both the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation should create a greater availability of funds for these loans, and we anticipate that mortgage bankers will become more active in this area of lending. Title VII would remove state-imposed impediments for lenders who wish to offer second mortgage and home improvement loans to consumers, and thus will truly benefit consumers.

Thank you very much for this opportunity to testify. I would be happy to answer any questions you might have.

The CHAIRMAN. Thank you.
Mr. Koelemij.

STATEMENT OF JOHN KOELEMIJ, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. KOELEMIJ. Mr. Chairman and members of the committee: My name is John Koelemij and I am a homebuilder and land developer in Tallahassee, Fla., and I've tried to bring some sunshine with me. I am testifying on behalf of the more than 118,000 members of the National Association of Home Builders, of which I am first vice president. NAHB is a trade association that represents this Nation's homebuilding industry. I would like to thank you for the opportunity to appear before your committee and testify on S. 2181 and S. 2134.

Mr. Chairman, as a Washington outsider, I am always intrigued by the use of language in Washington. Sometimes, words appear to have different meanings here. One word which has caught my attention over the past few years is deregulation. I lean in the direction of a definition written by Prof. Herbert Stein who said:

> Deregulation is a process of restoring free markets by eliminating the old, small regulations we are used to * * * and imposing new big regulation * * * with the result that the total number of regulations becomes larger and stranger.

With that as a background, I will proceed with my oral statement.

Mortgage credit needs are of vital interest to our industry. They are, in fact, survival for homebuilding.

SUBSTANTIAL SHORTAGE OF CAPITAL FOR HOUSING

We share the concerns expressed by the U.S. League of Savings Institutions homeownership task force that there is likely to be a substantial shortage of capital for housing during the remainder of this decade. They conservatively estimate the shortage at an average of $48 billion per year from 1984 through 1989. In fact, the gap cannot be avoided completely—even if the deficits are reduced. Among the factors contributing to the shortage, according to the U.S. League, is:

> The inability of home finance suppliers to compete successfully for a larger share of an inadequate capital pie—even with the help of new nontraditional intermediaries in the secondary market.

It is in light of this concern for an adequate supply of affordable mortgage credit that we must view the legislation before this committee today.

Mr. Chairman, we are opposed to any legislation that would permit lenders to engage in land development and residential construction which would put builders at a competitive disadvantage in financing their activities.

S. 2181 permits real estate investment development and brokerage. Even with the prohibition on construction activity and the 5-percent limit on investment and development activities, we are strongly opposed to this provision.

We prefer the approach in S. 2134, Senator Proxmire's bill, which does not provide these expanded powers.

S. 2181 states that investment and development of real estate are permissible, but construction activity is not permitted.

We do not find a definition in the bill of construction activity. Does that mean that a bank cannot own and operate a construction company? Does it mean the bank cannot be the prime contractor? How does the bank go about putting a building on the land which it is permitted to own? Can that be done by the owner of a construction company who serves on the board of directors or is a vice president of the bank? How can a bank develop real estate—as permitted by the bill—without engaging in some type of construction activity? We are not certain that any answers to these questions will be satisfactory, given the competitive advantage of banks in the marketplace.

Direct competition among financial institutions, independent builders, and developers is not equitable. Financial institutions can secure site financing at more favorable terms than are available to independent companies. They do not have to show the same profit as an independent because they will not foreclose on their own projects. In addition, their parent company can subsidize their operations.

A second problem is anticompetitive practices by financial institutions. We have experienced significant problems with savings and loan service corporations in the area of preferential lending. The financial institution offers below market construction and mortgage financing on projects in which it has an interest, in some instances refusing to extend loans except on projects in which they participate. This cuts off financing to their building competitors.

A final abuse is the tie-in arrangement. A loan customer may be obliged to obtain another bank service in order to obtain construction or permanent financing.

Another problem is the long-term possibility of vertical integration where financial institutions can control virtually all aspects of the real estate development business. This trend will eliminate competition and concentrate control of development in fewer, larger companies controlled by banks and thrifts. Those large institutions would then be freer to raise prices and to destroy price competition.

Banks and thrifts engaging in real estate development will actually harm the competitive system. Their success will be at the cost of the small- and medium-sized builder. This is approximately three-fourths of our membership—builders constructing 25 houses or less a year. These builders usually do not have alternatives for financing. They cannot bypass the banks and thrifts as can the larger builders. Especially in small markets, the smaller builder is almost wholly dependent on traditional lenders.

Mr. Chairman, I have been traveling around the country meeting with homebuilders over the past few months. Our members are increasingly expressing problems with savings and loan service corporations.

In 1981, we urged Congress and the administration to prohibit savings and loans from setting up service corporations that compete unfairly with local builders. At that time, we focused attention on savings and loans in Greenville, S.C. One S&L stated at that time that their "present policy regarding lending is that we take application on properties where we have either an ownership or a mortgage interest." Thrift policy remains unchanged today.

In Milwaukee, Wis. an S&L Service Corp. built 50 condominiums and sold only 10 over a 2-year period—then rented the remaining 40. The best they can do is get their capital back—the project cannot make money. Builders know when a service corporation has failed because word gets around. Even though there has not been much discussion about the health of service corporations a number of them are not making money.

These are not isolated examples in the South and the Midwest. They represent a pattern of activity that is occurring more frequently in communities throughout the country. In fact, I had a call this morning from Mr. Herder who had a leadership conference in Phoenix, Ariz. yesterday, and the expression of the leadership there of the local association expressed what I'm telling you here today.

Mr. Chairman, are we proceeding on the philosophy that the economy would be better off with fewer banks? Fewer banks might be easier to regulate, but at what cost to society? We hope that this possibility will be carefully considered before this committee acts on major new legislation.

OPPOSED TO THRIFTS EXPANSION INTO NONHOUSING ACTIVITIES

We are opposed to the expansion of thrifts into nonhousing activities until a viable solution is in place to provide adequate and affordable mortgage credit on a regular basis. As I mentioned earlier, greater demands will be placed on the availability of money for housing in the current decade. We feel strongly that emphasis is placed on a continued commitment to housing.

In addition, Mr. Chairman, we would like to insure that antitying language pertaining to the homebuilding industry provide real builder protection against tying arrangements. We support the language in both bills which explicitly authorizes trade associations to sue for injunctive relief on behalf of their members to enforce anti-tying provisions of present law. But we must remind you that litigation is a difficult and expensive process which does not always achieve the desired result.

Finally, Mr. Chairman, our national president, Pete Herder, has appointed a task force on financial deregulation chaired by Merrill Butler, past president of the National Association of Home Builders. That task force will study the long-term implications of further deregulation for the housing industry. The legislation before your committee is extremely complex and very technical. We have concerns with the direction in which deregulation is moving and we will be looking closely at potential effects of issues such as the expanded powers authorized in S. 2181, concentration, and the role of thrifts in mortgage finance. We hope that this committee does not see the need to move rapidly in the area of major financial institution legislation this year because we believe that there are many issues which need to be explored in greater detail.

I appreciate the opportunity to present our views and I will be pleased to share the results of our regulatory task force and submit that to you and the committee at a later time.

[Complete statement follows:]

STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB)
before
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
on
S. 2181, Financial Services Competitive Equity Act
S. 2134, Depository Institutions Holding Company Act
on
March 7, 1984

Mr. Chairman and Members of the Committee: My name is John Koelemij and I am a homebuilder and land developer in Tallahassee, Florida. I am testifying on behalf of the more than 118,000 members of the National Association of Home Builders, of which I am First Vice President. NAHB is a trade association that represents this nation's homebuilding industry. I would like to thank you for the oppportunity to appear before your Committee and testify on S. 2181, The Financial Services Competitive Equity Act, and S. 2134, The Depository Institutions Holding Company Act of 1984. In particular, I would like to address the impact of housing finance needs and several proposals for change in the financial services industries.

Mr. Chairman, as a Washington "outsider", I am always intrigued by the use of language in Washington. Sometimes, words appear to have different meanings here. One word which has caught my attention over the past few years is "deregulation". I lean in the direction of a definition written by Professor Herbert Stein who said, "Deregulation is a process of restoring free markets by eliminating the old, small regulations we are used to ... and imposing new big regulations ... with the result that the total number of regulations becomes larger and stranger." With that as a background ...

Outlook for the Housing Industry

Housing production represented one of the brightest spots in the national economy in 1983.

° The housing industry led economic recovery throughout 1983. Although investment in housing only accounted for about 3.4 percent of the nation's real gross national product in 1983, housing was responsible for about 30 percent of total economic growth, or for $15 billion of the $50 billion real increase in real GNP experienced during the year.

° 1983 was the strongest housing recovery year since World War II. The approximately 1.7 million homes started in 1983 was a 60 percent improvement from the 1.1 million unit annual production level in 1981 and 1982.

° A production increase of 641,000 homes in 1983 from the prior year created 924,000 man years of employment, $18 billion in wages and $8 billion in local, state and federal taxes. The first year of the housing recovery pumped $86 billion in new activity into the economy.

We expect the housing recovery to continue throughout 1984, with levels of activity comparable to those of 1983. However, even a relatively slight upward movement in interest rates could jeopardize the recovery, because mortgage rates remain just at the threshold of affordability for significant numbers of prospective buyers. It remains questionable, however, whether the recovery can continue beyond 1984 if, by then, annual federal deficits are still at their current annual level of about $200 billion. Economists are almost unanimous in their opinion that government borrowing will inevitably clash with the capital needs of private borrowers, drive up interest rates, and abort the recovery. This only emphasizes the necessity for Congress and the Administration to develop a bipartisan consensus on budget reductions in all areas and tax increases this year.

Mortgage Credit Needs

We share the concerns expressed by the U.S. League of Savings Institutions Homeownership Task Force that there is likely to be a substantial shortage of capital for housing during the remainder of this decade. They "conservatively estimate" the shortage at an average of $48 billion per year from 1984 through 1989. In fact, the gap cannot be avoided completely ... even if the deficits are reduced. Among the factors contributing to the shortage, according to the U.S. League, is "the inability of home finance suppliers to compete successfully for a larger share of an inadequate capital pie ... even with the help of new 'nontraditional' intermediaries in the secondary market."

It is in light of this concern for an adequate supply of affordable mortgage credit that we must view the legislation before this Committee today.

Real Estate

Mr. Chairman, I will focus the majority of my comments on provisions in S. 2181 which would permit expanded powers in real estate activity.

We are opposed to any legislation that would permit lenders to engage in land development and residential construction which would put builders at a competitive disadvantage in financing their activities.

S. 2181 permits real estate investment development and brokerage. Even with the prohibition on construction activity and the 5% limit on investment and development activities, we are strongly opposed to this provision.

We prefer the approach in S. 2134, Senator Proxmire's bill which does not provide these expanded powers.

In recent years, some financial institutions have begun to compete directly in real estate development with independent builders and developers. The added authority of banks to participate in real estate development, finance and sales would provide an enormous concentration of power in financial institutions, and promotes several anti-competitive practices.

S. 2181 states that investment and development of real estate are permissible, but construction activity is not permitted.

We do not find a definition in the bill of "construction activity." Does that mean that a bank cannot own and operate a construction company? Does it mean the bank cannot be the prime contractor? How does the bank go about putting a building on the land which it is permitted to own? Can that be done by the owner of a construction company who serves on the Board of Directors or is a Vice President of the Bank? How can a bank "develop" real estate (as permitted by the bill) without engaging in some type of construction activity? We are not certain that any answers to these questions will be satisfactory, given the competitive advantage of banks in the marketplace.

Direct competition among financial institutions, independent builders, and developers is not equitable. Financial institutions have the inherent ability to secure site financing at more favorable terms than are available to independent companies. Financial institutions can extend more favorable construction and mortgage financing to their projects. They can process their own home buying clients faster. They do not have to show the same profit as an independent in order to stay in business because they will not foreclose on their own projects and can subsidize their development operations when necessary from their parent operations.

A second problem is anti-competitive practics by financial institutions. We have experienced significant problems even with the more limited powers given to savings and loan service corporations. Normally, this takes the form of preferential lending. The financial institution offers below market construction and mortgage financing on projects in which it has an interest. Some thrift institutions have even refused to extend loans except on projects in which they have an interest, effectively cutting their building competitors off from their traditional source of financing. A final abuse is the tie-in arrangement. A loan customer may be obliged to obtain another service, such as a business checking account in order to obtain construction or permanent financing.

A third problem is the long-term possibility of financial institutions setting up companies that control virtually all aspects of the real estate development business. This vertical integration would involve the same company buying land, developing it, building, marketing, financing acquisition by its customers, and insuring mortgages. In addition to their real estate development powers, federal thrifts' service corporations already can acquire and rent commercial real estate, renovate commercial real estate, provide property managment services for their own prjects. This trend will eliminate competition and concentrate control of development in fewer, larger companies controlled by banks and thrifts. Those large institutions would then be freer to raise prices and to destroy price competition.

To permit bank holding companies to set up subsidiaries that can invest directly in real estate is a short sighted change that trades off the long-term interest of the free market system for possible short-term benefits to financial institutions and very few consumers. Using financial leverage, the bank holding company will be able to arrange preferential financing to the customers of its development subsidiary. They can undercut the small builder or developer who must obtain construction financing at market rates and whose customers must get permanent financing at market rates. We view large banks as a greater threat to competition than thrifts because of their enormous assets and remoteness from local communities.

Banks and thrifts engaging in real estate development will actually harm the competitive system. Their success will be at the cost of the small and medium sized builder. These builders usually do not have alternatives for financing. They cannot bypass the banks and thrifts as can the larger builders. Especially in small markets, the smaller builder is almost wholly dependent on traditional lenders. He cannot compete with them.

The subsidiary is not an answer to the question of risk and fair dealing. Rules written requiring arms-length transactions will not in fact preclude preferential treatment of a subsidiary by its parent corporation or affiliates. The risk to the parent may be reduced but will not be eliminated by the use of a subsidiary.

Concentration

Mr. Chairman, we are also concerned about further concentration of the financial industry. It is not yet clear what benefits have accrued to the consumer from the first wave of financial institution deregulation. We simply do not believe that anyone can state with certainty the end result of this desperate cry for more powers from those who are regulated in the financial services industry.

I do not hear consumers saying "give more power to my bank." I have not heard anyone say they would be better off if they had purchased their house from a bank -- or that they could better afford a home built on land developed by a bank. I certainly have not heard any of my colleagues in the building industry saying their business would be better off if they were employed by a bank.

The question is, what public service is being preformed by the granting of such expanded powers?

We believe that Senator Proxmire made good sense when he explained the role banks are to perform in our economic system. He said, "The essence of banking is to allocate a scarce resource-credit-to those enterprises where it can be most productively employed ... If bankers do their job well, the entire society benefits through higher economic growth. If bankers do poorly, society loses through lower rates of growth and productivity. This is the logic behind the laws that have sought to separate the business of banking from other commercial endeavors, and especially from the securities industry."

Banks should be as impartial as possible in allocating credit among alternative uses. If banks have a financial interest in real estate, insurance, or securities holdings the public purpose becomes clouded and impartiality diminishes.

The continuing consolidation of the financial industry through the growth of branch banks and multibank holding companies, forces small businesses to compete against large corporations, the federal government and foreign countries in their quest for capital. The home building industry is made up of tens of thousands of small community-based businesses. Approximately seventy-five percent of all home builders build fewer than 25 homes per year. This small-builder clientele must rely heavily on local lenders for project financing. These decisions are better determined at the community level and not in a city far removed from the project site and knowledge of community needs.

The result of the proposed legislation could mean fewer and larger banks, a scenario not in the interest of the small businessman. Normally, the bigger the bank, the greater the distance between the small business person and his final loan decision maker. The bigger the bank, the greater the differential between the discount from prime for big business and the points added above prime and charged to the small business persons. Finally, the bigger the bank, the fewer the small business persons who serve on the board of directors setting policy.

Some major public policy questions impacting on banking concentration and interestate banking have been advanced in a study entitled The Dynamic American Banking System authored by the Conference of State Banking Supervisors.

The report asks whether the authority to expand interstate ownership actually cures the conditions proponents cite as the major justification for such authority -- the latest financial services at competitive prices. Second, would such interstate authority reverse a fundamental American philosophy favoring local control of local money. The Report concludes with the following arguments in answer to these questions.

They point out that the number of giant nationwide organizations that would emerge would inevitably "be affected with a government perceived public interest" -- more so than is currently the case with large U.S. banking organizations. A high concentration of banking resources in a few such organization would make them highly susceptible to greater direct government controls and tend to remove them from the market process to which they are now subject".

Paradoxically, proposals for permissible interstate ownership and control under the guise of free enterprise could be the antithesis of free enterprise! Concentration of private power, centralization of government power and greater government control are interdependent. Just as it has not been possible to permit large industrial firms to fail (Chrysler and Lockheed being two prime examples), the government would also protect the giant banking organizations that would emerge out of nationwide branching against failure in the conventional sense. Such governmental protection against failure, however, provides protected organizations with a substantial competitive advantage over the non-protected. Such has already been demonstrated".

Mr. Chairman, are we proceeding on the philosophy that the economy would be better off with fewer banks? Fewer banks might be easier to regulate, but at what cost to society? We hope that this possibility will be carefully considered before this Committee acts on major new legislation.

We are opposed to the expansion of thrifts into non-housing activities until a viable solution is in place to provide adequate and affordable mortgage credit on a regular basis. As we discussed earlier, greater demands will be placed on the availability of money for housing in the current decade. Housing finance is in transition and the manner in which funds will be available is uncertain at a time when housing demand is increasing. We feel strongly that the emphasis for qualified thrift lending should be placed on a continued commitment to housing.

In addition, Mr. Chairman, we would like to ensure that anti-tying language pertaining to the homebuilding industry provide real builder protection against tying arrangements. We support the language in both bills which explicitly authorizes trade associations to sue for injunctive relief on behalf of their members to enforce anti-tying provisions of present law. But we must remind you that litigation is a difficult and expensive process which does not always achieve the desired result.

In 1981 we urged Congress and the Administration to prohibit savings and loans from setting up service corporations that compete unfairly with local builders. We noted that thrifts were forming real estate sales firms, and that these firms were permitted to sell houses built by the service corporation by offering mortgage loans at rates of interest lower than those offered by local builders. We are even more concerned about these anti-competitive practices today as housing production has increased and service corporation activity has expanded.

Finally, Mr. Chairman, our National President Pete Herder has appointed a Task Force on financial deregulation chaired by Merrill Butler, past president of the National Association of Home Buidlers. The Task Force will study the long-term implications of further deregulation for the housing industry. The legislation before your Committee is extremely complex and very technical. We have concerns with the direction in which deregulation is moving and we will be looking closely at potential effects of issues such as the expanded powers authorized in S. 2181, concentration, and the role of thrifts in mortgage finance. We hope that this Committee does not see the need to move rapidly in the area of major financial institution legislation this year because we believe that there are many issues which need to be explored in greater detail.

I appreciate the opportunity to present our views on this wide-ranging and vital area. We will be pleased to share the results of our Task Force analysis and recommendations with you during the year. I would be happy to answer any questions you may have.

The **Chairman**. Thank you, Mr. Koelemij.

Gentlemen, each of you, I understand your concerns fully and you bring up real concerns that this committee must take under consideration, certainly the safety and soundness and what is appropriate for various players in the financial services industry to do.

Mr. Koelemij, it disturbs me, though, that beyond the specific testimony, which I say I understand and you're correct that the committee needs to consider it carefully, but if there's anything I've learned on this committee, if somebody doesn't like what we're doing, the answer is always the same—that these are very difficult issues and need to be carefully considered, so wait.

That's just a copout. I'm not singling you out. Any witness that comes before us who doesn't quite like it, that's the usual thing.

DECISIONMAKING IS THE ANSWER

We had the Hunt Commission Report we were talking about a few minutes ago that talked about the problems in the thrifts in 1972. In 1982, we acted, when they were on their backs flat. If there's anything I feel, even if I totally and completely agreed with your positions, delay is not the answer to these problems. Decisionmaking is the answer to these problems, so you know what the ball game is and how you can act.

Again, I don't mean to jump all over you. It's a common thing to just say, well, let's wait, let's delay. How many years do we carefully consider problems over and over again? Congress is notorious for unwillingness to take action and make difficult decisions.

So that last part of your testimony, I hope that the homebuilders would be part of the process, be willing to contribute any additional information you have, let us know of your concerns. I think if I have any reputation, it is that I am willing to listen. I'm willing to meet with anybody at any time besides the hearings. I've been at most of your meetings at one time or another all over this country, your groups and others.

Don't kill the process. Fight for your particular positions, each one of you. As I've said to everybody, if you don't, no one else will. Don't kill the process or we're going to have a repeat of the same hearings I've heard for 9 years, that these are difficult problems and we've got to carefully consider them. I may spend four terms in the Senate and go home and say, "What happened? Nothing?" I spent 18 years or 24 years but nothing happened. That's traditional of Government.

You know, it's interesting, as a former mayor of Salt Lake City, I pick up the newspaper and it's been 10 years since I've been mayor of Salt Lake City and you just change the name of the present mayor and put mine back in there and some of the same things they're still arguing about, still haven't made any decision, still going on. So let's at least try and move ahead.

Mr. Treadwell, you looked like you wanted to make a statement or are you just——

Mr. **Treadwell**. Well, I'm ready to answer your questions.

The **Chairman**. Well, you're either lucky or unlucky, as you can decide, I'm only going to have about one or two questions for you so the other witnesses don't starve to death during lunch period because we are going to just have to continue on. The afternoon schedule is such that there's no way to take a lunch break.

Mr. Treadwell, you made the point that realtors that provide mortgage financing are not in the banking business, but such realtors merely provide a tie into financing and do not carry the loan itself but sell it to the lender.

Is there any danger of tie-in by realtors? We've certainly heard about a lot of tie-ins with banks.

Mr. TREADWELL. The system that we are developing, the so-called national mortgage access, will provide a clearinghouse that will be open to all proposed lenders to submit the types of mortgages and properties that they are willing to make mortgages on and the general basic description of them, and it's our purpose to make this available through the realtors so the prospective buyer can research the market—in other words, perfect the market. We do not intend to take any interest or any activity in that as far as making loans, even loaning and warehousing them temporarily. That would be done, if somebody wanted to get into the system and had a warehousing function—a mortgage banker, an S&L, a bank, a national organization of any kind that wanted to provide this service in that local community, then this information would be available simply as to the availability of funds from this particular source. The consumer then could make the selection based upon what they thought was in their best interest.

But I just want to make this crystal clear because of the letter that Mr. Gray had sent out yesterday to address that and clarify that this is not an attempt for the realtor to be involved in any way in getting into the banking business.

The CHAIRMAN. Well, what's the difference between a realty subsidiary that sells most of its loans off to the secondary market through its parent S&L? How is that different from a realtor that sells his loans off through such computerized mortgage programs like you've just described?

Mr. TREADWELL. Well, first, the realtor is not selling off its loans. He is simply telling the buyer that here are five different people who are willing to make the loans and the buyer then makes the contact with the mortgagee and the mortgagee would then put the funds to complete the transaction with the particular buyer.

MATTER OF SUBSIDIES

The fundamental distinction that is made between mortgage bankers, in my opinion and the National Association's opinion, is the lack of the subsidy where the S&L's and the banks have a subsidized program and competitive advantages with the Federal Government to assist them in accumulating funds. We think this is unfair competition for them to then come back and in effect have a tie-in arrangement which is not available to those real estate brokers who are not affiliated with some depository institution.

We're not concerned about competition on a level playing field and we certainly—while some of our members are concerned in their own business activities about the Merrill Lynch's, as long as the Merrill Lynch's raise their own funds without the subsidies, they are doing it through whatever economies that might exist in the marketplace because of their creditworthiness. But when the Federal Government intervenes and establishes the creditworthiness, then we feel that these people should not be competing.

The **CHAIRMAN**. Where in FDIC insurance is there a subsidy? By statute, all of the financial institutions who participate pay one-twelfth of 1 percent of their insurable funds and create that fund. At this point there's been no Federal dollars placed in those insurance funds other than the resolution of a few years ago when the institutions were in such difficulty, as I said, that if the funds run out we place the full faith and credit. But in actual practice, those are funds that are paid just like insurance premiums and private deposit insurance programs and some of the State programs.

You keep referring to subsidy.

Mr. **TREADWELL**. Well, there are other subsidies besides that, of course, but specifically——

The **CHAIRMAN**. I understand that.

Mr. **TREADWELL**. But specifically, that subsidy—I consider it a subsidy. No. 1, certainly having the deposit insurance is perceived by the bankers as extremely helpful in letting them accumulate deposits.

The **CHAIRMAN**. No doubt about it.

Mr. **TREADWELL**. Because they all advertise it. So it's their perception. I think it is the correct perception. There's no question that many of the institutions have suffered severe losses. If you look at the entire industry, the total amount of insurance collected from the total industry has to date covered all of the losses. I submit that if you plugged in the $8.4 billion that went to the IMF and considered that as part of the overall subsidy of the FDIC, which certainly there is a direct relationship, that you might come up with a different answer.

The **CHAIRMAN**. Well, we don't have time to get into that argument, but there's a great deal of lack of understanding of the IMF. If you want to try and make that tie-in, that just doesn't fit, Mr. Treadwell, at all. Are you aware that the net cost to the Treasury of the IMF over the last 10 years—do you know what it's been?

Mr. **TREADWELL**. No; I do not.

The **CHAIRMAN**. $100 million a year because the quota is at interest as a deposit with the IMF of which this country or any country has first call on its own quota. $100 million a year average net cost is the difference in interest that could have been earned if it were in domestic securities rather than being paid a lower rate of interest. So there's no $8.4 billion cost to the Treasury and it doesn't relate to FDIC.

Now I agree with you that there are great advantages to having FDIC insurance, psychologically safety and soundness and all that, but I just didn't want to leave it. It's been said several times today by previous witnesses as well. There are other subsidies and I understand what you are talking about, but FDIC to this point has been a self-paying fund. It isn't fair to indicate that it isn't.

Mr. **TREADWELL**. Well, let me describe it perhaps more precisely in your terms as an advantage provided by the Federal Government to depository institutions, and there are in fact other subsidies, without arguing the question of whether the FDIC actually is a subsidy.

But the point is that it is an advantage which is not available to most people in the community and our concern is that seeing these institutions which have accumulated large sums of money on the basis that they are a secure depository, the bedrock, basic safe institution for people to put their money in around the country, that they are now getting over into extremely—well, into general commerce and taking equity positions.

The CHAIRMAN. They're not taking equity positions yet.

Mr. TREADWELL. Well, in our business, sir, they are, and the specific examples which are included in my testimony, such as in Nebraska and Iowa—now these are State—in some cases State, in one case Federal.

The CHAIRMAN. We're dealing with Federal laws today which as yet do not allow these types of services.

Mr. TREADWELL. The *Nebraska* case is a Federal case. Glendale is also a Federal. And these are areas of our concern and I would agree with you that certainly we must move ahead at least in certain areas because the noncop cops that you referred to earlier are not really enforcing what appears to be the intent of Congress in the past in this area.

The CHAIRMAN. Mr. Teutsch.

Mr. TEUTSCH. Mr. Chairman, the committee does understand we're talking about bank holding companies and savings and loan holding company activities and not depository institutions themselves entering these businesses?

The CHAIRMAN. Yes; the committee understands that. I'm not sure a lot of witnesses do.

Mr. TEUTSCH. Well, I'm one of those who does.

Mr. TREADWELL. I do understand it, but my concern is that the artificial barriers, the Chinese wall that was referred to, do not in practice work as indicated by the noncop cops and some of the other instances which I've referred to.

The CHAIRMAN. I understand your concerns completely. All I'm trying to say is let's not bring up arguments to back up your concerns that are not accurate, like the FDIC is subsidized, and tie that into IMF which has no connection, or bring in bank failures which have nothing to do with what we're talking about today. You and other witnesses do that in almost every hearing. Penn Square, the Butcher situation in Tennesse, fraud, mismanagement would have occurred at any time at any place with or without what we're talking about.

So I only chastise you lightly. I understand your position completely and where you're coming from. I'm sure you're all aware that this bill narrows what Treasury wanted to do and if these services come out it will probably be narrowed further. We're in a discussion stage.

But to make a point, there's adequate evidence on your side to back up many of your positions without dropping off the cliff on things that have no relationship, and those bank failures have no relationship to what we're talking about here. Fraud, dishonesty, changing loans from one bank to another, and all that, I'm sure that the people involved in those situations weren't saying, "What's the Senate Banking Committee doing on deregulation today before we float these loans?"

Mr. KOELEMIJ. Just to comment on your observations that you made, I'd like to say that we are maybe an unusual group to be testifying on this bill, but we didn't ask for any extended powers for the housing industry so we have nothing to compromise with nor have we heard a great clamor for the banking industry to get into real estate development except from banks. So that's from where our opposition comes which I have testified today.

I can guarantee you that we will expeditiously look at the other details of the bill and submit our reactions to the committee.

The CHAIRMAN. No, you're not an unusual witness for this group. Housing is certainly a fundamental foundation of the economy of this country and what we do affects housing and real estate. You're certainly appropriate witnesses before this committee, not only today but in other times as well, and usually the homebuilding industry is the first one affected by difficulties in the economy and the last one to recover. So you're certainly appropriate witnesses to be testifying.

Mr. KOELEMIJ. I meant from the position that it's not a give-and-take on our part, so to speak. It's the reaction to what might happen in the deregulation if it became effective.

The CHAIRMAN. I understand.

Gentlemen, thank you very much. There will be, I guarantee you, additional questions for your response in writing. The questions might be better and the answers might be better that way, too. Thank you very much. We appreciate you being here.

[Response to written questions of Senator Garn follows:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM DONALD TREADWELL, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

Q. To what extent have national companies, such as Merrill Lynch, Coldwell Banker and ERA, become involved in the real estate sales business?

A. Large, national firms are engaged in real estate activity, but they do not account for a major share of the business. The real estate industry is comprised primarily of small-to-medium sized firms. Indeed, one half of 125,000 real estate firms have less than five sales associates.

The franchise organizations such as Century 21, Realty World, ERA, Red Carpet, Gallery of Homes and RE/MAX represent approximately 17 percent of all real estate firms. These affiliated firms account for nearly 30 percent of the national real estate market.

While it is true that the franchise organizations afford their member firms a national, regional or local identity which makes their names readily recognizable to customers and clients, it is important to remember that as a general rule these franchise organizations do not have an ownership interest in the real estate firms. Rather, the real estate firms operate as local independently-owned, small businesses, with each individual firms accounting for only a small share of the total real estate transactions in the country.

Q. Don't some of these organizations include mortgage financing and depository affiliates?

Recently, several realty firms, service organizations and retail establishments have begun developing a network of financial services for its clientele. In particular, a large, nationally-known securities firm has diversified its services into the real estate and mortgage lending area. Also, a well-known retail corporation has purchased a California based savings bank and has opened "financial centers" in their establishments which offer real estate, securities brokerage and insurance services.

Some realty firms have opened mortgage company subsidiaries, however, there are significant differences between mortgage banks on the one hand, and commercial banks and savings and loans on the other. A mortgage company is neither chartered by the federal government nor a state government and therefore does not enjoy the benefits of banks and savings and loans. When a mortgage company needs funds, it goes to the marketplace for them. It does not use FDIC or FSLIC insurance to attract capital. Further, mortgage banking companies do not have access to Federal Home Loan Bank Board advances or the FED discount window.

Q. What percentage of the real estate sales business flows through such national organizations?

A. Some analysts have argued that the industry is rapidly moving away from a large group of relatively small firms to one which is dominated by a small number of large firms. This trend was apparent in the 1979 to 1981 time frame as firms with five or fewer sales associates accounted for a smaller proporation of all real estate firms.

The trend towards bigness was sidetracked in 1982 by the dismal market conditions in the real estate business. In 1982 firms with five or fewer sales associates comprised a larger proporation of all firms in the industry. The upturn that real estate experienced during the last half of 1982 and the first half of 1983 renewed at least a moderate trend towards larger firms. However, the industry still functions, to a great extent, on a local basis and is dominated by small firms.

During the decade of the seventies, real estate franchise organizations enjoyed rapid and continuous growth in their recruitment of real estate firms. However, the first few years of the eighties have seen a reversal of that trend. In 1983, 16.8 percent of all real estate firms were affiliated with a national, regional, or local franchise organization. This is down from the 18.5 percent affiliated at the same time in 1982 and down substantially from the peak of 21.0 percent in 1981.

FRANCHISE PENETRATION

Year	Percent of Firms Affiliated With Franchise Organizations	Percent of National Market
1983	16.8	29.5
1982	18.5	28.2
1981	21.0	36.3
1980	18.7	29.3
1979	16.0	29.1

Q. Doesn't this indicate that consumers accept such firms and that the trend in financial service is to offer more than one service?

A. The concept of "one-stop" shopping or providing consumers with a variety of financial services under one roof has become popular with some service and retail establishments. However, while some companies have moved in the direction of establishing "financial supermarkets", it remains uncertain to what extent consumers are receiving any benefits from these affiliations and whether these affiliations are achieving corporate goals.

While we are not opposed to corporate conglomerates per se, we are most concerned with the conglomerate which enjoys competitive advantages in the marketplace by virtue of its federal "safety net". In particular, banks and savings and loan associations because of their federal charters are privy to specific competitive advantages in the financial marketplace.

The federal deposit insurance funds provide member depositories the advantage of using their insured status as a commercial draw to individuals who are deciding in which financial institution to invest their funds. Another advantage enjoyed by depository institutions is the ability to borrow money below market rates from the Federal Reserve's discount window and the Federal Home Loan Banks. Further, the tax treatment of federally chartered financial institutions provides strong federal tax support that regular businesses do not enjoy.

Availability and access to credit are the "heart and soul" of the real estate industry. To allow depository institutions to become third party brokers, would place them in the dual role of providers of credit and competitors for credit. Therefore, we would support legislation which would close the "non-bank bank" loophole and restore depository insitutions to their traditional roles in the marketplace.

NAR SUPPORTS SUCCESSFUL SUBCOMMITTE PASSAGE OF PATTERSON AMENDMENT

The National Association of Realtors worked closely with Representative Jerry Patterson to draft and generate support for an amendment to the Secondary Mortgage Market Enhancement Act, HR4557. This amendment gave statutory authority to both Fannie Mae and Freddie Mac to purchase second mortgages up to 50% of the limits on single family first mortgages. The Amendment was passed by the Subcommittee and the bill now awaits full committee consideration.

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Robert D Bannister
Senior Staff Vice President

May 24, 1984

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and
Urban Affairs
Washington, D.C. 20510

Dear Chairman Garn:

Please find enclosed answers to the questions submitted to John Koelemij regarding his testimony on March 7.

Thank you for the opportunity to respond.

Sincerely,

Robert D Bannister
Senior Staff Vice President

RDB:kok

Enclosure

QUESTION:

You mention that 75% of all home builders build fewer than 25 homes per year. What percentage of homes is bult by the large (say top 25 or 50) regional and national builders? Are they increasing their share of construction activity?

ANSWER:

The statistics below pertain to the size of the nation's professional residential construction firms.

Number of Units	Percentage of Builders					
	1959	1969	1976	1978	1980	1982
Small Builders						
Less than 10	41.6%	31.8%	38.9%	46.5%	46.2%	53.5%
11-25	27.9	25.2	26.8	26.3	24.3	19.1
Subtotal	69.5%	57.0%	65.7%	72.8%	70.5%	72.6%
Medium Builders						
26-50	15.6%	18.4%	15.6%	12.6%	12.4%	10.6%
51-100	8.7	12.2	9.3	7.1	7.9	7.0
Subtotal	24.3%	30.6%	24.9%	19.7%	20.3%	17.6%
Large Builders						
101-500	5.7%	10.4%	7.8%	6.3%	7.8%	8.0%
501 & Over	0.5	1.3	1.5	1.1	1.3	1.7
Subtotal	6.2%	11.7%	9.3%	7.4%	9.1%	9.7%

The estimated percentage share of housing starts during 1982 by builders in different size categories is as follow:

Number of Units	Percentage of Builders	Percentage Share of Units
Small Builders		
10 or less	53%	5%
11-25	19	7
Subtotal	72%	12%
Medium Builders		
26-50	11%	8%
51-100	7	11
Subtotal	18%	19%
Large Builders		
101-500	8%	49%
501 and Over	2	19
Subtotal	10%	68%

QUESTION:

While I understand that you are concerned about tie-ins (which dealt with the Garn-St Germain Act), what is your view of relationships between developers and thrifts, especially in states such as California - where state chartered thrifts may engage in broad service corporation powers? Should such affiliates be barred?

ANSWER:

I have major concerns over some of the relationships which have developed between developers and thrifts. While the Garn/St Germain Act addresses tie-ins this is not the only problem and there is no simple answer to the variety of issues that arise on the subject of developer/thrift relationships.

Some of our concerns on this issue are:

1. Thrifts have been a traditional source of financing for home builders. In recent years thrifts with service corporation subsidiaries have been competing with builders, putting the builders at a disadvantage.

2. Thrifts have the ability to secure financing for their service corporation subsidiaries on more favorable terms than home builders. In addition, thrifts can subsidize these real estate projects so they do not have to show the same profit as a builder in order to stay in business.

3. Some S&L's have openly stated that their policy regarding lending is to take applications on properties where they have either an ownership or mortgage interest.

4. Thrifts are inflating the price of land through "land flips" involving multiple sales on a single parcel.

5. Thrifts are purchasing land at inflated prices and holding the property for speculative gains. This increases the current price of comprable properties in the area.

6. Joint ventures are currently a financing option for a builder and a financial institution to explore. It would cause great concern if, through legislation, this form of finance became the only source of available financing for builders who did not have a private source of capital from which to finance their land development and investment.

Now if we could have panel 3 come up, this panel is composed of Mr. Michael Roush, legislative representative, National Federation of Independent Business; and H. R. Lively, on behalf of the American Retail Federation, president, Jewelers Financial Services, Inc., Subsidiary of Zales Corp., Dallas, Tex.

Gentlemen, we're happy to have you before us. Mr. Roush, would you like to begin?

STATEMENT OF MICHAEL ROUSH, LEGISLATIVE REPRESENTATIVE, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. ROUSH. Thank you, Mr. Chairman. I am here representing the National Federation of Independent Business, an organization that represents some 570,000 small businesses in the country, and, with your permission, I will just summarize my conclusions and not give the explanations. I commend the testimony to you for the background explanations.

The CHAIRMAN. You have my permission.

Mr. ROUSH. Thank you. First of all, NFIB forms its positions on almost all issues by polling its members and the majority establishes the position.

So summarizing the things that we don't like about S. 2181 first, the NFIB opposes allowing banks to cross over into commerce. We polled our members on this and it was a 61 to 29 percent vote, 2 to 1 against.

We also oppose breaking down the geographic restrictions on bank activity contained in title X.

The creation of consumer banks, which I think is in title I, is something that we also oppose.

Those are the primary things that we oppose. The rest of the things are things that we do support.

We support the preemption of State laws which allow banks in some States to engage in insurance activities in the other 49 States that they cannot engage in in their own State.

We support the application of existing geographic restrictions to banks that acquire S&L's so that the purchasing banks cannot utilize the more liberal thrift branching laws.

We support title VIII which was introduced separately as S. 1975, which allows banks to pay interest on business checking accounts. Also part of S. 1975 is the allowing of thrifts to offer interest paying demand deposit accounts to businesses other than those with whom they have a lending relationship, we support that. And we also support title IV which would require that the Federal Reserve Board pay interest on reserves held against demand deposit accounts.

As I say, this is a summary of the conclusions and the explanations and background are in the testimony.

One additional comment, quickly, is on some of the comments that Senator Sarbanes made and that you also made, to the extent that any industry collection of people comes together to decide how the financial industry should be structured in the future, and given the possibility, as Senator Sarbanes said, that we might arrive at some point where we don't want to be, I suspect it will be people like our members saying that they don't like where we have arrived at. So to the extent there's any kind of coming together of minds, so to speak, small business would like to be part of that.

[Complete statement follows:]

NFIB® National Federation
of Independent Business

The Guardian of Small Business

STATEMENT OF

MICHAEL O. ROUSH
LEGISLATIVE REPRESENTATIVE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: Senate Banking Committee
Subject: Deregulation of the Banking and Financial Services Industry
Date: March 7, 1984

Mr. Chairman, on behalf of NFIB's more than 570,000 small and independent business members, we appreciate this opportunity to express our concerns about deregulation of the banking and financial services industry. As a group that relies heavily on banks for credit, our members stand to be heavily affected by the decisions this committee makes regarding the legislation now before it. They remain skeptical that the deregulatory initiatives being discussed here today will be to their benefit.

During NFIB's testimony before this committee last year, we put forward a detailed account of small business' concerns regarding the deregulation of banking. Although we intend to focus our comments today on the specific legislation at hand, let us briefly reiterate the bases for our position.

As we noted in last year's statement, NFIB surveys show that 85% of the commercial loans made to operating small firms are provided

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by banks. According to a study by the Interagency Task Force on Small Business Finance, roughly three-quarters of this credit comes from small and medium-sized banks. Both studies indicate that small banks and banks in limited branching states provide better rates to small business and are rated better on subjective measures than larger banks and banks where unlimited branching is allowed. Despite the high degree of volatility and change in U.S. credit markets during the past few years, small firms have been fairly successful in meeting their credit needs. Small wonder then that our members are hesitant to embrace such wholesale changes in the banking structure as the current proposals entail.

The current crisis in banking has supposedly been brought about by nonbanking institutions offering deposit-like accounts and other traditional banking services while banks cannot enter into their lines of business. From this it does not necessarily follow that banks should be granted new commercial powers in order to remain competitive in the financial marketplace. The real questions seem to be, what is a bank, and what role should banks play in our economic system? Once those have been decided, then why shouldn't banking services provided by nonbanking institutions be subject to the same regulation as banks? This is a more rational approach than tearing down the longstanding separation between banking and commerce embodied in the Glass-Steagall Act and turning banks into commercial conglomerates. If banks are given the authority to sell insurance, real estate and securities, surely other lines of business will soon follow.

The banking groups have argued before this committee that their share of the financial services market is being eroded by the nonbanking financial conglomerates, and that they need expanded commercial powers if they are to survive and continue to serve their customers. They have provided no statistical evidence to support the claim that their market share has declined in recent years or to what extent it can be expected to decline if new powers are denied and how this would affect the services they currently offer. Instead, they assert that the demand for these changes is consumer driven and make vague promises that the principal beneficiary will be the consumers of financial services.

Small business, one of the major consumers of credit, does not share this sentiment. It is also apparent from the testimony presented before this committee on February 29th by the Consumer Federation of America, the American Association of Retired People, and other groups, that individual consumers are not the force pushing further deregulation. The truth is that banks, particularly the larger ones, are pushing for new powers not so they can better serve the general public of small depositors and businesses, but so they can more actively pursue the upscale market of well-to-do individuals, professionals, and mid-market growth companies which offer such handsome profits. The trend in recent years among banks has been to discourage small depositors and shift the burden of service fees onto smaller customers. Small businesses have been paying about 3 points above prime on average for loans during the past year.

NFIB believes that banks are chartered in part to serve the credit needs of businesses, not compete with them from a position of unfair advantage. Banks have a unique aura of credibility that other businesses cannot match. They have an existing client base that can be readily tapped. They are taxed differently than are other businesses. Finally, banks carry federal government insurance and have access to low cost funds from the Federal Reserve.

Our members fear that they may be at a disadvantage when asking for a loan from a bank that owns a competing subsidiary. They are concerned about anti-competitive tie-ins. And they see a potential diversion of bank deposits from commercial lending toward other revenue-producing activities. As a result, NFIB members have voted 61 to 29 percent against allowing banks to cross over the existing line between banking and commerce.

As for geographic restrictions on banking, the data available call into question the notion that liberalized branching automatically increases competition, thereby increasing the availability of credit, reducing its cost, and improving bank service to small borrowers. Small business people are worried that as geographic limits are phased out, the small banks on which they rely will be taken over by large banking conglomerates whose focus will be on deposit taking, consumer lending and lines of business other than making commercial loans. Thus, NFIB members have voted 74 to 20 percent against interstate banking.

These two policy statements by our membership are the determinants for NFIB's position on the Garn omnibus bill (S. 2181) and the Proxmire bill (S. 2134) now before this committee.

NFIB opposes Title I of S. 2181, which would allow bank holding companies to engage in insurance, real estate and securities brokerage. We recognize that major revisions have been made in this aspect of the bill since the concept was first introduced, but the changes only partially address the concerns of small business. Limiting the amount of assets that very large firms could invest in these ventures is an attempt to prevent undue economic concentration and excessive mingling of ownership among banks, S & Ls, and the large nonbanking financial conglomerates. While we are sympathetic to the goals of this limitation, it seems inconsistent to argue against the Glass-Steagall separation between banking and commerce as artificial and then to limit their entry into new businesses to 25% of assets. Both limits are arbitrary policy decisions. If the purpose is to deregulate, why establish a new barrier?

At any rate, the limit established by S. 2181 is insignificant. Only the 25 largest banks exceed the proposed limit of holding companies whose subsidiaries exceed .30 percent in total domestic deposits. The remaining 14,000 small and medium-sized banks would be free to combine in any way they choose. This is an attempt to deal with antitrust concerns by establishing a priori standards of concentration for the banking, insurance, real estate, and securities industries. We do not believe it is the most appropriate way to deal with a major antitrust issue.

S. 2181 also seeks to prevent tie-ins between banks and their insurance activities by providing a 30-day cool off period in which to cancel insurance purchased from a holding company subsidiary. Again, this is a step in the right direction, but it is not nearly sufficient. It simply does not follow that allowing a borrower to cancel insurance will prevent the lender from implicitly tying approval on a loan to the purchase of insurance from an affiliate. And what about tie-ins involving other commercial ventures, such as between a real estate affiliate and the bank as mortgagor? S. 2181 only provides anti-tying measures related to insurance activities. Much more needs to be done if anti-competitive tying arrangements are to be prevented.

Title I of S. 2181 would establish a whole new category of consumer banks, which really are only renamed "nonbank banks". Such a bank might be owned by any kind of organization but would not be subject to the Holding Company Act. Although a consumer bank could only operate where the McFadden Act, Douglas Amendment, or state law allows it to, it would take deposits but could not make commercial loans, with the exception of up to 5% of its assets in small business loans. This appears to be a concession aimed at gaining small business support. But its likely affect, as with nonbank banks, would be to increase the desirability of consumer lending relative to commercial lending and weaken the relationship between local pools of capital (made up of deposits) and the availability of commercial credit. We view the introduction of consumer banks as a step in the wrong direction.

There are some positive elements in S. 2181. For example, the preemption of state laws in Title I that allow banks to engage in insurance activities outside the state which they cannot conduct in the home state deals with a particularly egregious loophole in the current regulatory structure. This puts a state in the position of rewriting national policy on what banks may do as well as writing state law for the other 49 states. The preemption should be included in any legislation enacted by Congress.

We also support the application of existing geographic restrictions to banks that acquire S & Ls so purchasing banks cannot utilize the more liberal thrift branching laws. Citicorp has already made aggressive use of this loophole to expand its interstate operations in California, Illinois, and Florida, despite national policy to the contrary.

There are several other bills that are of interest to small business and have been incorporated into Sen. Garn's omnibus bill. Title VIII, introduced separately as S. 1975, would allow banks to pay interest on business checking accounts. NFIB has testified before the House Banking Committee in favor of this measure, although we did so with some reservations. These accounts are the only ones still waiting to be deregulated. Roughly half of our members are incorporated businesses which currently receive no interest on checking. Allowing banks to pay interest on these accounts should help small companies in their cash management.

We are aware that banks will see their costs increase if this legislation passes, with smaller banks being most affected. They argue that the cost will be passed along in the form of higher fees and interest rates on loans for those small firms that expect to benefit from interest on checking. It is our hope that as banks become more sophisticated at allocating costs through fee structures, these cost increases will be more efficiently spread among the entire customer base.

S. 1975 allows thrifts to offer interest-paying demand deposit accounts to businesses other than those with whom they have a lending relationship. Thrifts could thus more effectively pursue the new commercial lending powers granted to them by the Garn-St. Germain Act. We believe that this will increase the sources of credit available to small firms and thus are in favor of it. However, we recognize that thrifts currently face more favorable regulatory, supervisory, and tax treatment than do commercial banks. Congress must address this matter before long. NFIB does not want to see interest on business checking raise the cost of credit to small firms substantially or become the last nail in the coffin of small banks.

NFIB also supports Title IV of the omnibus bill, which was introduced as S. 1750, and would require the Federal Reserve to pay interest on reserves held against demand deposit accounts.

Finally, there is the matter of ratifying regional interstate banking contained in Title X of S. 2181. It is difficult to tell at this point what the impact of regional banking pacts will be. It may be that they will accelerate the process of bank consolidation as regional banks merge or acquire smaller local banks in order to withstand the onslaught from large money center banks. A more structured approach to phasing out geographic restrictions may serve small business more. NFIB will continue to stand on its support of the McFadden Act and Douglas Amendment against interstate banking until such time as the benefits of regional interstate banking can be substantiated.

The Depository Institutions Holding Company Act Amendments (S. 2134) offered by Sen. Proxmire is more in line with our member's positions than the approach contained in S. 2181. It is less comprehensive and calls for less dramatic changes in the banking industry. NFIB thus prefers the basic elements of S. 2134 to those in S. 2181.

In particular, we support the sections of S. 2134 that would close the nonbank bank loophole, prevent bank holding companies from engaging in nationwide insurance activities through a bank chartered in a state with permissive laws, and bring state-chartered nonmember banks under the provisions of the Glass-Steagall Act. Each of these are examples of the aggressive use of loopholes by banks or their regulators to circumvent the intent of longstanding banking law. They should be closed off as the first step in rationalizing our overall financial industry structure. If this is not done, we will have the unseemly appearance of bank lawyers and regulators setting public policy without input from Congress or parties at interest within the public at large, including small business and other consumers.

S. 2134 would also allow holding companies to offer mutual funds and underwrite and deal in municipal revenue bonds and mortgage-backed securities. Based on our membership votes, we cannot support these powers at this time. However, we recognize that wnen banks were orginally authorized to deal in general obligation bonds, revenue bonds were not a major factor in the municipal bond market. They now dominate the municipals market, and it makes sense to allow banks to deal in revenue bonds. We would not oppose S. 2134 on this basis. As for mortgage-backed securities and mutual funds, we are aware that the authority to offer these investment vehicles might enable banks to package long-term, fixed-rate loans and commercial mortgages to small businesses for resale in the secondary market. This is an intriguing possibility which should be explored further. Until such time as this option is made more specific with regard to financing small business, we must oppose granting banks this new power.

In summary, we want to underscore that NFIB has consistently supported pro-competitive, free market-oriented legislation. We do not seek to stop the inexorable developments of the marketplace or to turn back the clock. We are fully cognizant of the changes that have taken place in the financial services industry in recent years, as well as those that may lie ahead. What NFIB is saying is that there is little solid evidence which would lead us to conclude that banking deregulation will ultimately benefit small business. The banks have not as yet presented a convincing argument for granting them expanded commercial powers. Until such time, NFIB urges this committee to move with caution in altering the separation between banking and commerce or existing geographic restrictions on banks. In the meantime, Congress must act to close the loopholes that are allowing banks to circumvent the intent of national banking policy.

The CHAIRMAN. Let me just say I don't think there's too much fear of Congress acting precipitously. I have never known them to do so. I suspect that adequate time will be spent.

Mr. Lively.

STATEMENT OF H. R. LIVELY, ON BEHALF OF THE AMERICAN RETAIL FEDERATION; PRESIDENT, JEWELERS FINANCIAL SERVICES, INC., SUBSIDIARY OF ZALES CORP., DALLAS, TEX., ACCOMPANIED BY CHRISTINE EDWARDS, SEARS, ROEBUCK & CO.

Mr. LIVELY. Mr. Chairman, members of this distinguished committee. My name is Randy Lively and I am president of Jewelers Financial Services, a wholly owned subsidiary of Zale Corp., the retail jeweler. I am also chairman of the American Retail Federation Financial Services task force.

Joining me today is Christine Edwards of Sears, Roebuck & Co. Parenthetically, Mrs. Edwards is not going to make a statement but has joined me to assist me in answering any questions you may have.

[Complete statement follows:]

TESTIMONY OF

H. RANDOLPH LIVELY, JR.

Mr. Chairman, and Members of this distinguished Committee:

My name is Randy Lively and I am President of Jewelers Financial Services, a wholly owned subsidiary of Zale Corporation, the retail jeweler. I am also Chairman of the American Retail Federation Financial Services Task Force.

Joining me today is Christine Edwards of Sears, Roebuck and Co. The two companies we represent and the membership of ARF reflect not only the diversity of our industry but the companies which are active participants in various elements of the consumer financial services industry.

We are here today representing the American Retail Federation whose membership consists of 31 national retail trade associations, 50 state retail associations, the Greater Washington Board of Trade, as well as Corporate members. Through its members, ARF represents more than one million retail establishments. Our interest in appearing before this Committee today is as diverse as the industry and companies we represent.

Much of the legislation pending before this Committee under the title "Financial Services Competitive Equity Act" is not directly of interest to many segments of the retail industry. For others, the interest is paramount. The legislation which is before this Committee has the potential for significant impact on existing operations and business associations of retailers.

In our presentation today we wish to focus on three major points upon which retailers in general have a consensus position. I should add first that several of our major corporate members intend to file separate statements that intend to address their separate corporate concerns. Turning now to the general items of concensus: First, we believe strongly that future options for entry by retailers into various aspects of the financial services industry should be preserved. Second, we do not believe that adverse consequences will flow merely from retailers having an ownership position in various segments of the financial services industry, particularly consumer banks, savings and loan associations and securities firms. Third, we are convinced that retailers' involvement in delivering various financial services products is a healthy evolution in the marketplace.

Turning to our first point, the members of the American Retail Federation submit that one of the primary goals in appearing before you today is to appeal for the preservation of a future choice for retailers. This would include flexibility for individual retail companies to add ownership of depository institutions to other services already provided to their customers.

S. 2181 includes some provisions which further that goal. Some of the very positive aspects of that bill include the definition of consumer bank and the validation of the concept of a consumer bank as a specific and desirable type of financial institution. In addition, the goal of preserving future choices is supported by the treatment of the concept of a qualified thrift lender which maintains the lack of activity restrictions on unitary S & L holding companies while preserving their character as home mortgage lenders.

Retailers agree with the general approach of this Committee to consider the implications of orderly deregulation. This would include the dismantling of unnecessary barriers which exist between those companies in general commerce and depository institutions. We strongly disagree with the premise that intrinsic harms will exist merely because of the control by a retailer of a depository institution. For example, the substantial history and record of the ownership of saving and loan associations by diversified, non-banking entities has produced no evidence of unacceptable risks or of harmful practices in those institutions. To the contrary, those companies have acted prudently while fulfilling their fiduciary responsibility to depositors.

Both the consumer bank treatment and the qualified thrift lender treatment would permit retailers to own a depository institution with no new restrictions being imposed on the retailers non-deposit activities other than existing measures aimed at safety and soundness considerations. Permitting retailers to participate in the marketplace through these provisions to de-regulate are heartily endorsed by the American Retail Federation.

The third point we would like to make is that retailer involvement in delivering financial services is part of a healthy evolution in the marketplace. This evolution is evidenced in today's marketplace. To understand this better it may be helpful to review retailers current presence in the financial services industry. Generic financial services are of two broad types - those provided to businesses and those provided to consumers. Retailers today are engaged in both types of services. Some of the financial services activities in which retailers are now involved are as follows:

- Ownership of depository institutions.
- The ownership of insurance companies providing a full range of insurance products such as mortgage, life, property, casualty, and credit life.
- The issuance of national and local credit cards.
- Providing billing and remittance processing to third parties.
- Providing credit authorization services and the communications network to third parties.
- The ownership of ATM's in some states.

- Joint ventures with depository institutions in the offering of a broad range of services which include ATM's, offering certificates of deposit and providing general financial services to third parties.

- Ownership of full service securities firms.

- Ownership of financial intermediaries dealing in commercial paper.

- Consumer and commercial real estate brokerage and affiliated financial activities.

- Mortgage banking.

- Consumer finance lending activities.

As is evidenced by these activities, the impact of any legislation on the financial services industry will necessarily include an impact on the present retailing industry. In addition, many of the issues before this Committee are irrevocably tied to the significant strides which have been made in technology and in the mediums available to deliver various financial services effectively and conveniently to consumers and businesses alike. Integration into retail systems of these various technologies for rational business reasons has inevitably identified areas in which our customers can be better served than in attempts to maintain the traditional distinctions. For example:

- The ATM owned and operated by the retail grocery chain brings a new level of convenience to consumers in obtaining cash for the purchase of the retailer's products or for the cash needs that the consumer may have outside of normal banking hours.

- The laborious and risky process of cashing checks to provide the consumer with this convenience at a much lower cost to the retailer is being provided by the ATM with its growing acceptance.

- Other questions which involve who should absorb the cost of these emerging technologies and delivery systems is also a matter of significant concern to retailers.

- Other issues which this Committee will debate impact on questions of pricing, cost transfers, or on the transfer of subsidies.

The American Retail Federation urges that deliberations on these questions should be developed to the fullest extent lest we find pricing configurations which might create competitive disadvantages and cost burdens to retailers as the revolution in the payments delivery system continues.

In summary, retailers recognize that with the age of electronics and sophisticated communication and information delivery systems that there may be further revolutionary impact that will require this Committee to evaluate, on a periodic basis, what these innovations may have evoked in the requirements of statutory and regulatory provisions covering the delivery or the providing of financial services to consumers and to businesses.

Let me turn briefly to address two other titles of S.2181 and their impact on retailers.

In Title IX retailers have a strong interest in how this Committee will treat the control of fraud activity involving credit cards. In our view, the approach taken in Title IX to protect consumers from loss as a result of the fraudulent use of credit cards and credit card account numbers is the correct one. It identifies the improper purposes for which account numbers can be used and prohibits disclosure of the numbers for those purposes. It does, however, permit all other disclosure of account numbers.

The consumer credit marketplace is, indeed, dynamic. For that reason, it is quite literally impossible to specify every legitimate use that today is made of account numbers. Legitimate uses of account numbers are as numerous as the merchants who use those numbers. It goes without saying, therefore, that it also is quite literally impossible to identify and describe every type of legitimate use that will be made of account numbers in the future.

Thus, Title IX of S. 2181 follows the only acceptable legislative path through the thicket of credit card protections: it identifies and prohibits the improper uses of account numbers and permits all other uses. Legislation that would take the opposite approach -- permit account number disclosure for a few enumerated purposes and prohibit it for all others -- would have a stultifying effect on the applications of innovative management techniques as well as inhibit creative marketing efforts. Accordingly, ARF could not support any such legislation, but it does support Title IX of S. 2181.

Title X of the bill encourages the recent experimentation by the northeastern states in allowing interstate banking. While retailers would prefer to see this issue addressed on a national basis, we support the states' attempts to address the issue through interstate compacts. Such experimentation ultimately will serve to remove arbitrary geographical barriers making it easier and less expensive to provide financial services to American consumers.

We wish to make the emphatic point that retailers are not suggesting a total lack of regulation. The need for protection of the safety and soundness of depository institutions through the regulatory and oversight process is required. However, we believe that the need is for a reasonable level of regulation aimed at controlling specific definable risks. Existing regulation of the financial services industry goes beyond these specific needs. S. 2181 takes a positive step to reduce these unnecessary regulations and barriers.

Finally, we would urge the Committee not to consider piece-meal legislative solutions in the area, such as a moratorium, grandfathering, or the closing of so-called loopholes. Our reasons for this stem from the general principles which we have already set forth. There is, as we have stated, absolutely no evidence that the ownership of certain kinds of financial institutions by non-financial entities has produced or is likely to produce any adverse consequences to the public. The issues of retail participation in the financial services marketplace should be approached without preconceived notions. A moratorium which requires divestiture as of an arbitrary date totally prejudges the issues involved.

Moreover, by imposing a moratorium Congress freezes the competitive situation in a very uneven way. This approach would have the impact of less competition in the marketplace and a more limited range of services which may be offered at potentially less competitive prices. In the long run, a moratorium of the type proposed thus far would only adversely affect the consumer by retarding the development of a financial services marketplace.

Grandfathering existing situations produces many of the same consequences. Its only advantage is that it does not arbitrarily penalize companies that have lawfully acquired certain kinds of institutions by forcing divestiture before the question of what the legal framework should be is totally resolved.

Finally, as to closing so-called loopholes, the Committee should satisfy itself that it is actually dealing with loopholes and that closing them is indeed in the public interest. In summary, we feel that the

Committee should very deliberately consider the pros and cons of what the finacial services marketplace of the future should look like and deal with the matter in a comprehensive fashion.

I would like to thank the Committee for this opportunity to present the views of American Retail Federation. I would be pleased to respond to questions the Committee Members may have.

The CHAIRMAN. Thank you very much.

I just have one quick question. Mr. Roush, you mentioned you oppose the creation of consumer banks and at the same time you made a statement about banks being interested in up-scaled customers and so on.

First of all, consumer banks is not a creation. They already exist. They have existed in my State for 75 years. Maybe we should have used a different name. A lot of people think it's a new creation. It is not. But it's my understanding of the situation that, primarily, industrial banks, certainly in my State, are consumer banks as they are talked about in this bill have deliberately served the lower end of the scales.

I'm just wondering if there's some conflict there in the testimony, that you're worried about banks getting into up-scales, serving the richer customers and so on, and not being interested in little people, and yet oppose a bank that has traditionally served little people.

Mr. ROUSH. The fear conveyed to me is that such banks would weaken the link between local pools of capital and consumer lending. And to the extent that there is previously existing evidence to the contrary, then I would have to correct my statement.

The CHAIRMAN. Well, at least in my State they have existed for more than 75 years and there are more of them than there are savings and loans in my State and nobody seems to feel that they've been taken.

Do you have any questions of this panel?

Senator SARBANES. No, Mr. Chairman.

The CHAIRMAN. Gentlemen, I apologize for the long delay. We obviously scheduled too many witnesses this morning. Thank you very much.

Could we have panel 4, composed of Mr. Henry B. Schechter, director, housing and monetary policy, AFL–CIO; and Mr. H. Robert Erwin, Jr., chairman, credit committee, National Consumers League.

Mr. Schechter, before you start, I want to say something to you. You have been in this position before. You have testified before the committee many times and I want it on the record that the next time Mr. Schechter is invited to testify that he be in the first panel.

Mr. SCHECHTER. Thank you, Mr. Chairman.

The CHAIRMAN. Because you have been incredibly patient and I don't think it was by design, but nevertheless, it has happened to you again and next time it will not happen. You will be first and then you can leave while all the other witnesses wait. Please go ahead.

STATEMENT OF HENRY B. SCHECHTER, DIRECTOR, HOUSING AND MONETARY POLICY, AFL-CIO

Mr. SCHECHTER. Mr. Chairman, Senator Sarbanes, I appreciate the opportunity to present before you the views of the AFL-CIO on S. 2181 and S. 2134.

Although I will have a plea on one subject, I will be addressing the broader issue of what this legislation might lead to.

TITLE I WOULD OPEN THE DOOR FOR THE BANKS

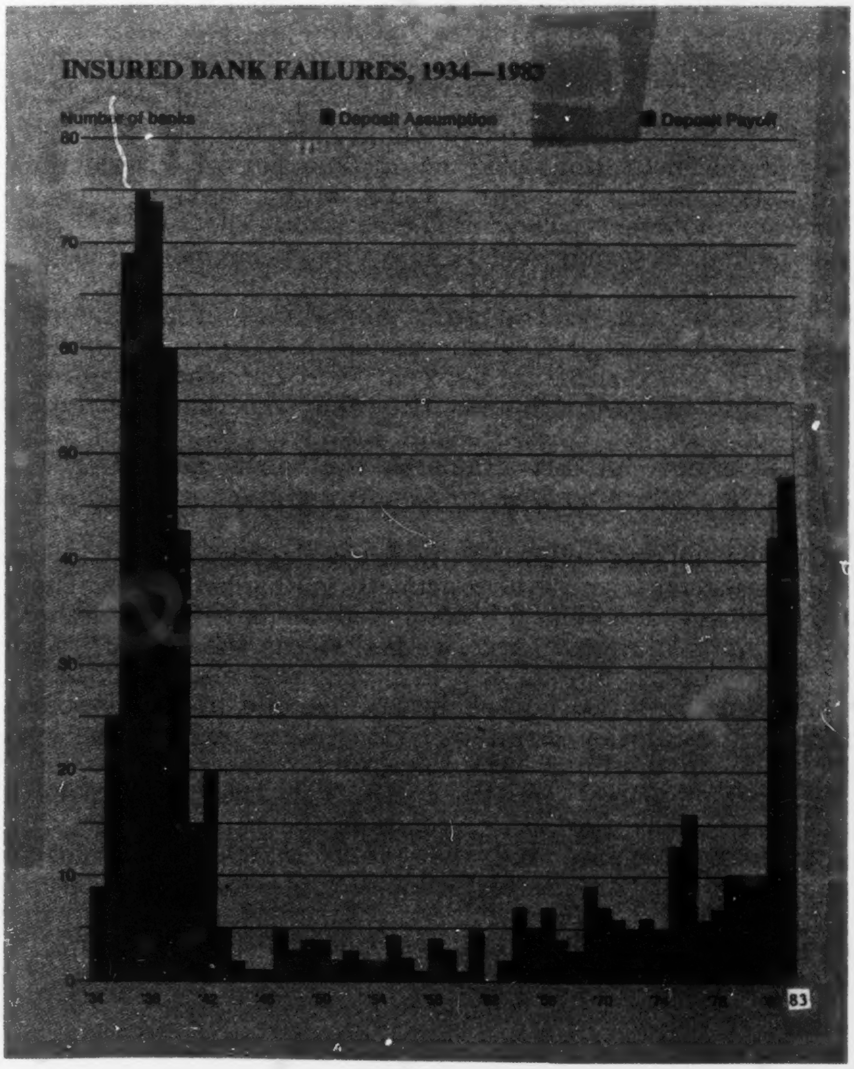
Title I of S. 2181 particularly would open the door to a restructuring of the institutions performing financial service functions in the country. Most of it I think would be the banks which are the vehicle for monetary policy implementation. They operate the national payments system and handle foreign payment transactions needed for international trade. They are also the safekeepers of other peoples' money. The great importance of these functions became painfully evident when we had to have a bank holiday in 1933. There is a correlation between what happened then and the whole history of bank failures. After that experience of the Great Depression, we got Glass-Steagall and we got other legislation which, in effect, put restrictions on the banks, particularly as to their lending terms and as to separating the securities business and so on.

After the shakeup following the Great Depression we had a wonderful period for a while of practically no bank failures. Then we started getting deregulation again and we have had another upsurge of bank failures. In fact, we had one in the mid-1970's when, for a while, the regulation Q wild card period also permitted institutions to compete for household savings, and in that process the competitive escalation of interest rates takes place as the lenders each try to get the funds. And then the process continues with the higher cost of money, and the institutions are bound to have to seek higher returns, and that results in the rising of interest rates and the cost of money, and, that is also matched by a decline in prudence. It just happens as lenders are pressured to invest more.

I did not put in the statement a chart because I couldn't reproduce it very well, but I would like to submit it for the record.

[Chart follows:]

CHART 1



SOURCE: Federal Deposit Insurance Corporation

Mr. SCHECHTER. This chart shows the number of failures annually. I did add the 1983 figures which I got from FDIC and you can see from the shape of the chart what happened to the level of failures.

Now as it is, to the extent that we've had deregulation there have been estimates that the increased competition for funds has caused interest rates to rise already in the last few years so that it's higher than it otherwise would be.

Now the authorization for the banks to engage in more activities would intensify the scramble for funds and the pressure to place funds in high-yield high-risk investments. More rather than less surveillance and regulation of the banks would be needed. Monetary policy would be hurt because the Federal Reserve Board would be handling so many more different types of regulatory supervision duties that they would have to exercise. They, among other things, would be determining what sort of activities are of a financial nature and therefore to be permitted; they would be given applications by institutions when they want to go into new activities and the Fed would have just 60 days in which to respond. Otherwise, the institutions could go ahead and perform these activities.

So that there would be increasing pressure and the monetary policy needs which require more attention and thoughtfulness in this technologically advanced age than ever before would probably have to be neglected more than they have been.

Also, the authorization of securities activities, including issuance, underwriting, public sale, or distribution of securities, would be authorized for affiliates of banks under the bank holding company. The bank directors and officers, if I interpret it correctly, could serve in similar capacities in affiliates that deal in securities. There will be temptations to guide cash flows from one affiliated enterprise into another that promises high yields.

This is of particular concern in connection with insurance operations. As was illustrated by the recent experience of the United-Baldwin Corp., which was not a bank but it owned a savings and loan, and it had to go into bankruptcy after the State insurance regulators required a halt to improper diversion of insurance funds in order to meet other obligations of the conglomerate.

Now, both bills try to guard against potential requirements by bank or S&L's subsidiaries of holding companies that borrowers shall buy insurance from its insurance affiliates. Nevertheless, at a minimum, there would be a perception on the part of many borrowers that the purchase of insurance would enhance their chances of getting a loan. In addition, subtle pressure could be exerted by loan officers to give their insurance affiliates an unfair advantage over competitors. Some 15,000 agents of insurance companies who are members of the United Food and Commercial Workers Union, an affiliate of the AFL–CIO, would be adversely affected. Expansion of banks into the insurance field would also further the concentration of economic power and reduce the bargaining power of consumers. The AFL–CIO is strongly opposed to the proposed permission for bank holding company affiliates to engage in insurance underwriting and sales.

The range of activities that a bank holding company could engage in would be broadened by S. 2181 to include activities of a financial nature.

CONCENTRATION OF POWER THROUGH ACQUISITIONS

Now in order to limit the concentration of economic power through acquisitions by large bank holding companies, S. 2181 provides that a bank holding company with more than 0.3 percent of domestic deposits could not acquire or merge with a nonbanking company engaged in permissible activities if, after the acquisition, the holding company would have more than 25 percent of its capital invested in one nonbank activity. That description would be applicable to 22 bank holding companies with $7 billion or more in deposits under their holding companies.

Among the five largest in terms of deposits, 25 percent of capital would range from $650 million to $1,300 million. The largest bank holding companies, who already have vast accumulations of financial resources under their control, would be in the best position to add more. They don't have to, of course, get complete control. They could get sufficient equity ownership to have control.

Large bank holding companies, when acquiring businesses of a financial nature, would gain control over total financial resources that would generally be a multiple of the amount invested.

On the whole, the limitations against concentration would, for the foreseeable future, leave room for a good deal of additional concentration of economic power.

Now the idea behind a lot of what is proposed is that it would result in benefits for the consumer, small business, the farmer. That might be true initially while this competition takes place, but as the companies with large resources at their command can drive out competition, they would be in a position then to charge interest rates or charge for services at levels that would be to the detriment of consumers.

S. 2134 would also amend the Glass-Steagall Act to permit a securities affiliate of a holding company to deal in and underwrite municipal securities. There could also be a bank affiliated with the securities affiliate and they could have interlocking boards of directors. The AFL–CIO is opposed to such arrangements.

The AFL–CIO is also opposed to the savings and loan unitary holding company idea proposed in S. 2181 and S. 2134 because of the same objections as those previously stated to the expansion of permissible activities for bank holding companies.

Title IV is apparently designed to compensate depository institutions for the loss of earnings on reserves they are required to hold against money market deposit accounts, super NOW accounts, and new transaction accounts authorized by the Depository Institutions Deregulation Committee after January 1, 1982.

However, the depository institutions can offer Federal deposit insurance which the money market funds cannot offer. The history of increases and decreases in money market funds and money market deposit accounts since the latter were authorized makes it quite evident that the depository institutions enjoy a tremendous advantage as far as most depositors are concerned.

The estimated total required reserves against these money market deposits and super NOW accounts is $13.6 billion. On that amount, the Federal Reserve would have to pay interest to the institutions holding these accounts, an amount conservatively estimated at about $1.2 billion annually.

The payment of net earnings made annually by the Federal Reserve Board to the U.S. Treasury would have to be reduced by an equal amount.

Title IV is not needed for competitive equity purposes. It would aggravate a serious national debt problem that keeps interest rates, trade deficits, and unemployment high. Its enactment would be contrary to the public interest, and it should be stricken from any proposed legislation.

Title V deals with disclosure requirements of leases and agreements. Chapter 2 of the title would have many of the requirements for disclosure so loosely drawn that the value to the consumer is dubious and it is urged that they be tightened up and also that the lessor be made subject to liability in certain instances described in section 123(b) where he is absolved of responsibility.

Title VI deals with fair deposit availability and would be a welcome needed addition to the law. However, section 609(b) is similar to 123(b) of title V and should be similarly revised.

Title VII would preempt State credit laws designed to protect business and consumer credit. It is now 11 months since the previous Federal preemption on State ceilings on business and agriculture loan interest rate laws expired. Have any particular States lagged behind in the economic recovery because their interest rate ceilings are too low? To restore the Federal preemption is to remove an opportunity for the people of the State, through their legislature, to protect themselves against the burden of exorbitant interest rates upon their local economies. We are opposed to such restoration.

The amendments in section 703 on "Consumer Credit" would seem to nullify such acts as the 1982 Arkansas constitutional amendment which raised the State 10 percent ceiling on small consumer loans to a 17-percent limit.

It would be unfair to require places like Arkansas to act again to revise their usury rate limits. All State actions taken during the period after the effective date of the 1980 act should not be preempted in a manner analogous to that envisioned under the bill for business and agriculture loans where there was some action taken by the States since 1980.

Section 703 of the bill lifts provisions of State constitutions or laws restricting or limiting in any way the charges and other terms of consumer loans. We urge that the section be deleted.

The CHAIRMAN. Mr. Schechter, we've got an additional problem. This just isn't my day in conducting a hearing. That is a vote going on and both Senator Sarbanes and I are going to have to leave. Would you consider me intolerably rude if I asked you to put the rest of your statement in the record so that we could hear from Mr. Erwin so that he isn't totally cut off from being allowed to speak?

Mr. SCHECHTER. I'll be glad to. I was only reading a summary, Senator.

The **Chairman**. I understand you were and, as I said, you're going to be the first witness next time you appear before this committee.

[Complete statement of Mr. Schechter follows:]

84-12

Testimony of Henry B. Schechter, Director, Office of Housing and Monetary Policy, American Federation of Labor and Congress of Industrial Organizations on S. 2181 and S. 2134, to Permit Depository Institutions and Their Parent Holding Companies to Engage in Additional Financial Activities Before the Senate Banking Committee

March 7, 1984

Introduction

I appreciate the opportunity to present the views of the AFL-CIO on S. 2181, the Financial Services Competitive Equity Act, and S. 2134, the Depository Institutions Holding Company Act of 1983.

Title I of S. 2181 on Financial Institutions Competitive Equity would open the door to a restructuring of the institutions performing financial service functions in the United States. Bank or savings and loan holding companies, or affiliates of a bank subsidiary could engage in real estate, insurance, securities, and other business activities that the Federal Reserve Board finds are closely related to banking or managing or controlling banks or to be of a financial nature. The holding companies could also acquire consumer banks which do not make commercial loans, in their own states and in other states whose laws permit it. As indicated by the S. 2181 title, these changes are intended to allow the banks and thrift institutions to compete with the merchandise chain stores and securities underwriters and sellers who have branched into various activities of a financial nature, and have also established money management accounts.

Instead of restricting and/or regulating the financial activities of non-banks, the legislative trend being pursued in S. 2181 is toward deregulation of banks and thrift depository institutions. Reliance would be placed upon competition to produce efficiency and cause benefits to be passed on to consumers. This approach would mark a relaxation of concern for the special role that the banks and other financial depository institutions have been assigned and play in the economy. They are the vehicle for monetary policy implementation, operate the national payments system and handle foreign payment transactions needed for international trade. They are also the safekeepers of "other peoples' money." The great importance of these functions became painfully apparent when the onset of financial collapse necessitated a bank holiday in 1933. Subsequent legislation restricted the activities of banks to keep them sound and provided deposit insurance. Most of their accounts are federally insured, and their reserves are subject to regulation by the Federal Reserve Board, which also is their lender of last resort. While retaining these government safeguards, banks have obtained relaxation of lending restrictions and the advent of bank holding companies has allowed them to get into related activities.

Some Historical Pespective

The record of bank failures in relation to changes in statutory and regulatory restrictions provides a perspective that should not be ignored. Despite the enactment of protective and restrictive banking regulation in 1933, given the position that many banks were in by then and the economic depression a shake-out was unavoidable. The peak number of 75 insured bank failures ccurred in 1937. The annual number of failures did not fall below 15 until 1943, but from that year through 1963, the number never exceded 5 and was 3 or less in most of those 21 years. The relatively good record, achieved in good part because of statutory restrictions on types of bank lending and activities, became the rationale for successful advocacy to relax the statutory limitations.

A Reg Q regulation relaxation in mid-1973, permitted unlimited interest payments on so called "wild card" savings accounts. It led to competitive escalation of interest rates and high-risk lending by banks, particularly to real-estate unvestment trusts, which were being advised by the banks and were doing unsound construction lending. Some large banks ended up owning the buildings. In 1975 and 1976 the number of insured bank failures jumped to 13 and 16, respectively.

In 1979 through 1981, except during the few months of credit controls in 1980, rising competition amoung investment intermediaries for household funds plus a tight monetary policy caused interest rates to rise. Competition to make loans to gas, oil and coal producers, to government securities dealers and to foreign countries and firms became intense. In the process, prudence declined. The failures of dealers in government securities and of the Penn Square Bank, which had been making loans to oil exploration and oil equipment firms, revealed that some of the largest banks in the country had been financing operations of the failed firms. When Latin-American countries could not meet scheduled payments on tremendous components of debt, again, a number of the largest banks were significant creditors. While the large banks, themselves, did not fail, their intensification of competition for funds and for loans had an impact on financial markets, and if they had been in more activities might have suffered more serious consequences. In 1982 and 1983 the number of insured bank failures were 42 and 48, respectively.

Potential Adverse Economic Impacts

The degree of depository institution deregulation, thus far, plus the rise of competition for funds from other intermediaries has also had an impact in raising interest rates to a higher level than would otherwise prevail. Estimates of the effect of this factor upon the interest rate level range from 1 to 3 percentage points. That, in itself, discourages large investment outlays. Related to the increased competition for funds and the range level of interest rates is increased volatility of rates and the extreme preference for short term investment by households and by the intermediary lending institutions. This factor also discourages large investment since 5 to 10 year loan terms involve either large debt service payments or the risk of having to refinance at a high interest rate. Industrial investments currently are overwhelmingly for equipment, rather than new plants, even in some industries operating at a high ratio of maximum capacity. These influences would increase with further deregulation and increase of competition for funds and for loans.

The larger money center and regional banks and parent holding companies are the financial powerhouses of the country. If and when they are let loose in the new entrepreneurial pastures contemplated in Title I of S. 2181 there will again be potential dangers for the economy. The bank holding companies and their banks and affiliates will be in a position to direct large financial resources into activities which are being served by others, perhaps resulting in reduced costs to consumers at first, but leading to higher consumer charges after the smaller competitors have been driven from the field. The large banks will also be able to spread across state lines with the establishment of consumer banks and acqusitions of thrift institutions, increasing their financial resources and leading to greater concentration of economic power in related activities that can be financed. However, as efforts to increase shares of total household deposits are pursued by the various competitors for funds, interest rates on savings will remain high or rise. Interest rates on loans, consequently, will remain high or rise. This will mean continued high financing costs, for business, government and consumers.

As high-cost money has to be invested, the pressures for high yield placement of funds, including foreign lending, will mount. More, rather than less surveillance and regulation of banks will be needed. Congress recognized that need in connection with foreign lending last year and wisely increased regulatory supervision of such operations as part of the International Monetary Fund legislation.

Monetary policy will be hurt because of the vast multiplication of different types of regulatory supervision that will be heaped upon the Federal Reserve Board. S. 2181 would require the Federal Reserve Board to issue regulations defining activities that are of "a financial nature" which would make businesses engaged in such activities eligible for acquisition by bank holding companies. Both S. 2181 and S. 2134 would require the Board to promote competition between bank holding companies and others offering the same financial services. Furthermore, bank holding companies could engage in permissible activities 60 days after notifying the Board, unless the Board objects or extends the period for another 30 days. As it is, a great deal of time of the Federal Reserve Board members and staff is spent in connection with proposed holding company acquisitions. The proposed additional S. 2181 duties could well overload the circuits at the "Fed." Monetary policy needs more attention and thought than ever, but it probably would get less if S. 2181 is enacted.

Title I - New Activities and Concentration of Economic Power

Title I of S. 2181 would create an institutional framework to permit depository institition holding companies to engage in insurance underwriting and brokerage and in real estate investment, development and brokerage. Both S. 2181 and S. 2134 would authorize securities activities, such as issuance, underwriting, public sale, or distribution of bonds, stocks, debentures, notes, etc. A depository institution securities affiliate could engage in securities activities. Such activities could not be conducted by a bank itself, but could be conducted by either the bank's parent bank holding company or by a separate affiliate of the holding company. Furthermore, an officer, director, or employee of a bank would also be permitted to serve at the same time in such capacities with its depository institution securities affiliates.

Concentrations of economic power could be developed as bank directors and officers could serve in similar capacities in affiliates that deal in securities underwriting and sales, real estate development, and insurance sales and underwriting. Such dual capacities for the individuals involved would invite conflicts of interest. There are provisions that are supposed to prevent such abuses. Thus, a member bank and its affiliates may engage in certain transactions only if the terms and conditions, including credit standards, are substantially the same as, or at least as favorable to the bank as those prevailing at the time, for transactions with non-affiliated companies. If all the terms and conditions are "substantially" the same -- they generally are not exactly the same -- and since banks do have limits as to resources, they could give their own affiliates priority.

There will be temptations to guide cash flows from one affiliated enterprise into another that promises high yields. That is of particular concern in connection with insurance operation reserves, as illustrated by the recent experience of the United-Baldwin Corporation, which had to go into bankruptcy after state insurance regulators required a halt to improper diversion of insurance reserves to meet other obligations. Conflicts between federal bank regulators and state insurance regulators could be expected to arise when a bank holding company has a controlling interest in an insurance operation subsidiary and can influence the investment of long-term reserves.

Both bills recognize and try to guard against potential requirements by bank or savings and loan association subsidiaries of holding companies that borrowers shall buy credit life insurance, or property insurance from its insurance affiliate. S. 2181 would require banks or thrift institutions to notify borrowers that insurance may be purchased where the borrower chooses, not to solicit insurance until after a commitment for credit extension has been made, and not to set unusual conditions for acceptability of insurance obtained elsewhere. S. 2134, and also S. 2181, would authorize trade associations to sue for injunctive relief on behalf of their members to enforce anti-tying arrangements under present law.

Nevertheless, as a minimum, there would be a perception on the part of many borrowers that the purchase of insurance would enhance their chances of getting a loan. In addition, the availability of insurance from the loan officer or someone else in his office, as well as subtle, oral pressures could be exerted by loan officers of banks and savings and loan associations to give their insurance affiliates an unfair advantage over competitors. Some 15,000 agents of insurance companies who are members of the United Food and Commercial Workers Union, an affiliate of the AFL-CIO, would be adversely affected. Expansion of banks into the insurance field would further the concentration of economic power and reduce the bargaining power of consumers. The AFL-CIO is strongly opposed to the proposed permission for bank holding company affiliates to engage in insurance underwriting and sales.

Affiliates could be helped in capturing market shares away from competing firms in the various non-banking activities. As the financial conglomerates gained greater concentrations of economic power, the American consumer would suffer because of reduced competition. Similar objections arise with respect to savings and loan holding companies.

The Bank Company Holding Act would be amended to permit bank holding companies to engage directly in a broader range of activities. Instead of the present requirement that the activities be "closely related to banking," they could be "of a financial nature" and embrace the various insurance and real estate activities that have been mentioned. There are certain limitations. For example, a bank holding company's investment in real estate development would be limited to no more than 5 percent of its primary capital.

Bank holding companies would also be authorized to acquire one or more FSLIC-insured institutions.

Section 7 of the Bank Holding Company Act would be amended to provide that no state may prohibit an affiliation between a national banking association and a company engaged in certain activities authorized by S. 2181, a use of federal preemption power.

Another amendment to the Bank Holding Company Act would permit bank holding companies to acquire shares in any company that engages only in activities authorized for depository institution security affiliates, and the activities may then be conducted directly by the bank holding company and through a non-bank subsidiary. A depository institution's security affiliate could deal in and underwrite municipal securities, certain industrial development bonds, securities of an investment company, and promissory notes secured by real estate mortgages and interests therein. Such activities would permit bank security affiliates to perform the strategic function of tapping the capital market to finance local governments, secondary mortgage markets, and other activities. It would be one more activity contributing to the accrual of economic power of bank holding companies and their affiliates.

Appropriately, the SEC would be the designated agency for enforcing a bank security affiliate's compliance with legal requirements for transactions in municipal securities. With prior approval of the SEC, however, an investment company affiliate could utilize the services of its bank affiliate as custodian of its securities, to act as trustee or custodian, or deposit designated proceeds with the bank. The Act would, thus, open the way for preferential choice of the bank by the securities affiliate for services related to financial transactions.

Another vehicle for greater control and centralization of financial capital by bank holding companies would be authority to acquire consumer banks in states which permit such acquisitions by a bank holding company located outside of the state in which the consumer bank is located.

A "consumer bank" is defined in S. 2181 as being in situations that would be the same as a bank, but that does not engage in the making of commercial loans. Under that definition, a consumer bank may accept deposits that the depositor can withdraw on demand. Such a consumer bank, furthermore, could make personal and household loans, residential mortgage loans, and credit loans. It could also make investments in commercial paper, certificates of deposit, broker call loans, federal funds, mortgage-backed securities, and similar instruments. Such investments could provide a vehicle for the shifting of funds from an affiliate consumer bank to the commercial bank subsidiary of the parent bank holding company. To the extent permitted by state laws, a bank holding company could acquire consumer banks in many parts of the country. Furthermore, a member bank or any of its subsidiaries could engage in certain transactions with any affiliate, if the terms and conditions are substantially the same as those prevailing for transactions with non-affiliated companies. Permissible transactions include the sale of securities or other assets, including assets subject to an agreement to repurchase. Through such arrangements banks could borrow funds from affiliates for investment in projects elsewhere, such as land development and building construction loans. Problems in meeting the credit needs of local businesses and communities could result.

In order to limit the concentration of economic power through acquisitions by large bank holding companies, S. 2181 provides that a bank holding company with more than 0.3 percent of domestic deposits could not acquire or merge with a non-banking company engaged in permissible activities if, after the acquisition, the holding company would have more than 25 percent of its capital invested in one non-bank activity. On the basis of an estimated $2,338 billion in total domestic deposits, bank holding companies with $7 billion or more in deposits would be under the aforementioned restrictions. There are 22 bank holding companies that fall under that restriction.

The proposed restriction against economic concentration has two drawbacks. First, as might be expected, among the 22 large bank holding companies subject to the restriction, those with the largest deposits tend to have the larger amounts of capital. Thus, among the five largest in terms of deposits, 25 percent of capital would range from $650 million to $1,300 million, but the amount represented by 25 percent of capital is in a range of only $236 to $295 million for the 5 among the 22 largest that have the smallest deposit amounts. Therefore, the largest bank holding companies, who already have vast accumulations of financial resources under their control, would be in the best position to add more.

Furthermore, since many bank holding companies ranking below the first 22 in domestic deposits are also fairly substantial, ranging from $4.0 to $5.5 billion in domestic deposits, their one-fourth of capital would range between $77 and $224 million.

Since, in the case of both the largest and smallest of the top (50) large bank holding companies, they would generally be acquiring businesses of a financial nature, the total financial resources over which control would be acquired would generally be a multiple of the amount invested in equity shares to gain full or partial equity ownership.

On the whole, the limitations against concentration would, for the foreseeable future, leave room for a good deal of additional concentration of economic power, tending to place the bank holding companies in a more advantageous position relative to the rest of the economy.

There is also a combination of looser regulation and expanded powers of activity, with interlocking directorates for different activities by affiliated entities. This combination offers a potential for inequitable treatment of unaffiliated enterprises, and disadvantageous treatment for consumer and business borrowers. The AFL-CIO, therefore, opposes the provisions of Title I of S. 2181 dealing with bank holding companies and the proposed new permissible activities.

S. 2134, while it would not permit as much objectionable expansion of bank holding company activities as S. 2181, would also amend the Glass Steagall Act to permit a securities affiliate of a holding company to deal in and underwrite municipal securities, advise investment companies selling such securities, and underwrite and deal in mortgage-backed securities. The holding company itself or a non-bank subsidiary could conduct the securities business. There could also be a bank affiliated with the securities affiliate and they could have interlocking boards of directors. The AFL-CIO is opposed to interlocking directors between an underwriter and potential purchaser of securities.

Savings and Loan Unitary Holding Company

In the savings and loan holding company area, S. 2181 would set up a new mechanism whereby a unitary savings and loan holding company would not be subject to restrictions placed upon savings and loan holding companies whose subsidiaries engage in the new powers granted by the bill. To enjoy this privilege, the thrift subsidiary of the savings and loan holding company would have to be a qualified thrift lender (QTB). Such a thrift subsidiary would not itself have the new powers of insurance or real estate securities and other permissible activities provided under the bill, but there would be no limits on the extent of the parent holding company's activities in the permitted area. A QTL would have to meet one of two tests: (1) have no more than 25 percent of its assets in certain designated types of commercially related loans; or (2) have more than 60 percent of its assets in residential real estate loans and securities. Under S. 2134 to qualify as a unitary holding company the savings and loan subsidiary must have at least 60 percent of its assets in residential mortgages or related investments and be operated as an independent association, separate and distint from the business of the parent or its affiliate. The AFL-CIO is opposed to the Savings and Loan Unitary Holding Company idea both in S. 2181 and S. 2134 because of the same objections as those previously stated to the expansion of permissible activities for bank holding companies. However, if such legislation were to be enacted, the S. 2134 version of a unitary savings and loan holding company would be preferable because it requires a substantional percentage of the savings and loan assets to be in residential mortgages or housing related and because it requires that the saving and loan operation remain independent.

All title numbers shown hereafter are with reference to S. 2181.

Title IV

Title IV, with the heading Competitive Savings Incentive, is apparently designed to compensate depository institutions for the loss of earnings on reserves they are required to hold against Money Market Deposit Accounts, super NOW accounts, and new transaction accounts authorized by the Depository Institutions Deregulation Committee (DIDC) after January 1, 1982. Their competitors for such funds, the money market funds, do not have to set aside such non-earning reserves and presumably are in a better competitive position than depository institutions to pay higher interest rates in order to attract household savings for investment.

However, the depository institutions can offer federal deposit insurance which the money market funds cannot offer. The history of increases and decreases in money market funds and Money Market Deposit Accounts since the latter were authorized, shown in Table 1, makes it quite evident that the depository institutions enjoy a tremendous advantage as far as most depositors are concerned. The federally insured institutions, starting from zero in November 1982, have had a continuous growth of Money Market Deposit Accounts, reaching an aggregate total of $377 billion by the end of January 1984. Over the same period, the aggregate total held in money market funds declined from $232 billion to $166 billion. The depository institutions do not need the interest payments on reserves to achieve competitive equity.

The advantage of the depository institutions is even greater when super NOW accounts are included. As of February 1, 1984, the total of super NOW accounts plus Money Market Deposit Accounts at federally insured banks and thrift institutions was $415 billion. The estimated total required reserves against these accounts is $13.6 billion. On that amount, the Federal Reserve would have to pay interest to the institutions holding the accounts at a rate equal to the average earnings rate by the Federal Reserve on its government securities portfolio, conservatively estimated at 9 percent. Currently, therefore, about $1.2 billion annually would have to be paid to the depository institutions.

The payment of net earnings made annually by the Federal Reserve Board to the U.S. Treasury would have to be reduced by an equal amount, and the federal deficit would, of course, be increased by such an amount, plus the interest on $1.2 billion added to the federal debt.

Title IV is not needed for competitive equity purposes. It would aggravate a serious national problem that keeps interest rates, trade deficits, and unemployment high. Its enactment would be contrary to the public interest, and it should be stricken from any proposed legislation.

TABLE I

	Money Market Deposit Accounts (MMDAs) (Billions of Dollars)	Money Market Funds (Billions of Dollars)
1982		
November	---	$232.1
December	$ 43.2	206.6
1983		
January	189.1	197.6
February	277.7	189.4
March	320.5	180.3
April	341.2	171.5
May	356.8	169.6
June	367.3	164.6
July	368.4	164.4
August	366.3	164.7
September	366.9	163.0
October	367.4	165.5
November	369.1	165.5
December	372.4	162.6
1984		
January	376.7	166.1

Sources: Federal Reserve; Investment Company Institute

TABLE 2

Estimated Reserves on Super NOW Accounts and Money Market Deposit Accounts
February 1984
(Billions of Dollars)

Super NOW Accounts	$37.6	
Estimated required reserves		2.3[1]
Money Market Deposit Accounts[2]	$377.8	
Estimated MMDA reserves		11.3
Total estimated reserves		$13.6

Note: All figures are as of February 1, 1984, based on the H6 Federal Reserve Statistical Release.

[1] Reserve requirements on transactions accounts are 3 percent of the first $28.9 million in an institution and 12 percent on amounts above this figure. In small banks with assets below $750 million, the ratio is in the 5-6 percent range. In larger institutions, the reserve ratio is somewhat higher. In these estimates, a 6 percent ratio is used.

[2] There are no reserve requirements on the first $2.2 million of an institution's MMDAs. A rate at or approaching 3 percent applies to amounts above $2.2 million. The estimate used here is based on a 3 percent reserve requirement.

Title V

Title V, on leases and rental purchase agreements, deals with disclosure requirements of such leases and agreements. In Chapter 2 of the Title, many of the requirements for disclosure are so loosely drawn that the value to the consumer is dubious, and it is urged that they be tightened up and also make the lessor subject to liability in certain instances (Section 123(b)) where he is absolved of responsibility. Thus, in Section 111(d), it is specified that information required to be disclosed may be given in the form of estimates and identified as such when the lessor does not know the exact information. This would leave an unlimited degree of latitude, as to estimates that may be given. There should be a requirement for a warning to the consumer that these estimates may be low or high by some stated degrees of error.

In Section 111(e), the lessor is absolved of any responsibility for inaccuracies as a result of any act or occurrence after delivery of the required disclosures. As a minimum, the lessor should be required to immediately inform the consumer of the inaccuracies and corrections that would be in order.

Under Section 112, paragraph (8), the lessor should be required to furnish the consumer with estimated amounts of fees or taxes that the consumer may have to pay directly in connection with the transaction.

In paragraph (10), it should be required that the consumer be advised as to the specific dollar amounts for which he may be liable if the lease is terminated earlier.

In Section 114, paragraph (4), instead of referring the consumer to the contract for an explanation of possible other charges, such as late payment, default, etc., such possible penalty fees should be disclosed along with other information with dollar amounts given for each item.

In Section 122(a)(4), the class action amount that may be recovered from a lessor is limited to the lesser of $500,000 or 1 percent of the net worth of the lessor. There are leasing businesses which may be conducted largely with borrowed funds. The lessor may have very little net worth and 1 percent of that amount would not be a great enough penalty to deter a lessor from doing business under false representation which could cause consumers to suffer financial damage. I is recommended, therefore, that the 1 percent by changed to 5 percent or some minimum amount, such as $100,000, should also be included.

Section 123(a) absolves the lessor from certain liabilities for violations of requirements under certain sections of the Act if within 60 days after discovering an error and before certain actions are taken by the consumer the lessor notifies the consumer of the error and makes adjustments in the account as necessary. How does the consumer know when the lessor actually discovered the error?

Section 123(b) would absolve the lessor for a violation if he has evidence to show that the violation was not intentional and resulted in a bona fide error. Examples of bona fide errors that are cited include clerical, calculation, computer malfunction and programming, and printing errors. Such errors would be errors of negligence or incompetence and absolution should not be given.

Title VI

Title VI deals with fair deposit availability and would be a welcome needed addition to the law by having depository institutions disclose its policies with respect to when a customer may withdraw funds deposited by a check and by prohibiting delays by a depository institution in computing interest on funds deposited by check. However, in Section 609(b) a depository institution would be absolved from any civil liability if a violation of the law was not intentional and resulted from a bona fide error. Examples of a bona fide error that are given include clerical, calculation, computer malfunction and programming, and printing errors. Some of these types of errors constitute negligence or incompetence, and the depository institution should be liable for violations of this type which may cause financial injury to depositors.

Title VII

Title VII, on credit deregulation and availability, would establish federal preemption of various types of state credit laws designed to protect business and consumer borrowers.

Title V of the 1980 Depository Institutions Deregulation law allows state-chartered, federally insured depository institutions to charge on consumer loans the same interest rates permitted national banks, subject to the right of the states to override at any time. Thus, these institutions may charge the highest of three rates: (1) 1 percent over the discount rate on 90-day commercial paper at the Federal Reserve Bank in the Federal Reserve district where the institution is located, (2) the highest rate allowed to any lender under state law for the type of loan involved, (3) or the rate specifically prescribed for state banks.

The present bill's Title VII on credit deregulation and availability would amend Title V with regard to consumer loans and business and agricultural loans. It would preempt state interest rate ceilings on business, agricultural, and consumer credit. States are given a 3-year period in which they may reject the federal preemption and impose restrictions of any amount and in any form. Moreover, this title would preserve the actions of those states that had overridden the federal preemption of business and agricultural interest rate ceilings in the 1980 Act.

It is now eleven months since the previous federal preemption of state ceilings on business and agriculture loan interest rate laws expired. Have any particular states lagged behind in the economic recovery because their interest rate ceilings are too low? Who, except the lenders, has been for restoration of the federal preemption? To restore the federal preemption is to remove an opportunity for the people of the state, through their elected state legislators, to protect themselves against the burden of exhorbitant interest rates upon their local economies. We are opposed to such restoration.

We strongly oppose the lifting of consumer loan usury limits which we feel are effective in limiting the interest charges paid by consumers. States can and have regulated these charges in the best interest of their residents and a federal preemption is unjustified.

The amendments in Section 703 on "Consumer Credit" would seem to nullify such acts as the 1982 Arkansas constitutional amendment which raised the state 10 percent ceiling on small consumer loans to a 17 percent limit. The bill would appear to create a situation where, as in Arkansas, the recent (November 1982) expression of the people's will with respect to consumer interest rate ceilings would be swept aside. Such states would have to act again to override the bill's preemption and to set consumer rates within their borders. The recency of the interest rate ceiling adjustment -- after the 1980 Act -- suggests that this action was taken in a deliberate and considered way and should not be set aside lightly.

It would be unfair and burdensome to require places like Arkansas to act again to revise their usury rate limits. It would be more fair to preserve any actions of states with regard to the setting of consumer interest rates, at a minimum to preserve all state actions taken during the period after the effective date of the 1980 Act in a manner analogous to that envisioned under the bill for business and agriculture loans. This is contained in Section 702, of the bill amending Section 512 (b) of the 1980 Act.

Section 703 of the bill lifts provisions of state constitutions or laws restricting or limiting in any way the charges and other terms of consumer loans. This is an overly broad deregulatory act not in the public interest. We believe that the states should have the right to regulate charges such as discounts, points, and similar fees and charges paid to creditors in order to protect the public from misleading and excessive consumer credit costs. By allowing interest and other fees and charges to be calculated and imposed in any and every way, it makes it more difficult for consumers to understand credit transactions and to intelligently exercise choices in the marketplace. It also permits extenders of credit to obtain consumer signatures on technical, legalistic contracts which may be misconstrued by borrowers with resultant great financial penalties, and at times loss of the family home or car. The latter event can occur, in the absence of safeguards, for example, where delay in prompt payment of a small late charge, following a late installment payment, places the loan technically in default. We urge that the section be deleted.

It should be noted that the proposed legislation would enact national policies that are not even-handed toward banks and consumers with regard to protection or preemption of states' rights. Thus, in Title VII, state usury laws and credit term protections for consumers would be preempted, as the lenders have advocated. On the other hand, in Title I, Section 104(f), a bank holding company could not acquire an interest in a consumer bank located in a state other than the state in which its consumer bank subsidiaries had conducted their operations, unless specifically authorized by laws of the state in which the consumer bank to be acquired in whole or in part was located.

Title VIII

Title VIII, the Demand Deposit Deregulation Act, would permit the payment of interest on demand deposits at the same rates permitted for NOW accounts under regulations that the Depository Institutions Deregulation Committee would be directed to promulgate. Although the interest rate to be paid would be under a regulated ceiling, there would not be any prohibition against competition by institutions in the related services that they could offer. For example, banks probably could give depositors free checks printed with the depositor's name, they could sell travellers checks to depositors without charging a commission, they could, upon request, provide cashier's checks drawn against accounts without charge, and they could reduce minimum required balances to relatively low amounts and permit unlimited numbers of checks to be used by a depositor. Such free services would be implicit additional interest payments. Furthermore, in the developing environment of deregulation, at some point, the ceiling on the permitted interest rate might be raised, if not eliminated.

Title VIII would mark the beginning of a return to the permitted payment of interest rates on demand deposits that had been allowed before the Great Depression. While there is some debate as to how much effect competitive escalation in interest rates paid on bank deposits had in inducing banks to make risky loans prior to 1929, observation and logic would suggest that this was a factor. Lenders faced with higher costs of money are inexorably driven to reach for higher interest rate loans although greater risks are involved.

Even over the last two decades, there has been some correlation between levels of interest rates and levels of bank failures, as indicated in the historical perspective presented on pages 2 and 3 of this testimony.

In 1983, there continued to be significant numbers of insured banks and savings and loan associations that had to be rescued with federal insurance agency funds. In addition to the pressures for unsound investment that would arise from higher cost money as depository institutions competed for demand deposits, the average cost of money for the institutions would rise because of payment of interest on checking accounts which heretofore have not required payment of interest. As a result, lenders would have to raise interest rates on loans to higher levels than would otherwise be necessary. The effect of such higher rates will be to raise financing costs for producers of goods and services who in turn would pass such increased costs on to consumers in increased prices. Built-in inflation would be created.

The AFL-CIO urges that Title VIII be disapproved.

Title IX

Title IX covers fraudulent use of credit cards and debit cards. It amends the Truth in Lending Act and the Electronic Fund Transfer Act to close loopholes in the laws which permit credit card frauds to go unpunished and to stiffen penalties for those convicted of fraud.

This title is based on congressional findings from hearings in 1983 that credit card fraud in the United States now exceeds $1 billion annually. This $1 billion is ultimately passed on to consumers in the form of higher interest rates.

The elimination of such fraud is thus in the public interest and should be pursued through legislation.

The CHAIRMAN. Mr. Erwin, please go ahead.

STATEMENT OF H. ROBERT ERWIN, JR., CHAIRMAN, CREDIT COMMITTEE, NATIONAL CONSUMERS LEAGUE

Mr. ERWIN. Mr. Chairman and Senator Sarbanes, I want to thank the committee for inviting me to speak today on behalf of the National Consumers League.

I'm reminded of a time a couple years ago when I appeared before a legislative committee in Annapolis and about 6 o'clock in the afternoon I was called upon to testify at the end of a very long day. I told the chairman on that occasion that there are times when a good advocate realizes that the less one says, the more one helps one's cause, and I suspect that that may be the situation now.

BATTLE OVER WHO GETS THE LARGEST SLICE OF THE FINANCIAL PIE

You have my testimony. I'm not even going to try to summarize it. I do want to touch on just two or three very quick points and then I'll let you get off to your vote.

I think it's enormously important for the committee to keep in mind what's really going on in these bills and indeed out in the marketplace itself. It's a battle among financial institutions for who's going to get how large a slice of the financial pie.

I think what we often forget is that we, American consumers, are the pie that they are fighting over and it's us they're sitting there debating over how large they're going to slice us apart.

I always get worried when I hear businesses talk about what's good for consumers and what's good for their customers. It particularly concerns me when bankers, insurance agents, and real estate brokers worry about consumers' financial well-being.

I'm always reminded of the guy who calls me up, invites me out to lunch at a very expensive restaurant, and during the course of the conversation says, "Oh, by the way, bring your checkbook." Now I know I'm not going to pay for the lunch, but I know I'm going to end up paying for something. I get the impression a little bit that that's what's going on here, that the financial institutions are inviting all of us consumers to come sit down at this marvelous table of deregulation and are also saying, "Oh, by the way, bring your checkbook." And the real question is, How much is it going to cost us?

In that sense, sitting here listening to all of these speakers this morning, I'm struck by the number of different visions in various people's crystal balls. I'm certainly happy that I'm not warranting any of those crystal balls, because not all of them can be right by any means. Nor do I suggest that the National Consumers League's crystal ball is any better than anybody else's.

But there are a couple points I want to make, based on deregulation in Maryland, that I do think are relevant to the committee in considering these bills and that you ought to keep in mind.

As you may recall, Delaware was one of the first States to totally deregulate consumer credit in February 1981. Maryland followed suit in July 1983, and there are a few things that I've noticed, anyway, that have happened in Maryland since July 1983 that I think the committee should be aware of, and keep in mind, in considering these bills.

First of all, we have not seen a wonderful world of, at least, price competition in the area of consumer credit. In fact, what happened is the financial institutions have used deregulation to make price competition more difficult rather than less difficult.

In saying that, I'm referring to the proliferation of all of the associated kinds of fees that are charged in connection with consumer credit that don't have to be disclosed as part of interest. They're separate from interest.

What this does is, it makes it difficult, if not impossible, for consumers to go into the marketplace and competitively shop based on the price of credit. They may do it based on convenience and any number of things. Competition exists, but it isn't price competition.

We have seen all different kinds of fees crop up in Maryland, to the point that the APR of truth-in-lending is frequently meaningless. Indeed, during a discussion about deregulation, I had one industry representative say to us straight out:

> We've done market research. We know a 20-percent APR meets consumer resistance. The reason we want deregulation is so that we can charge annual membership dues and other kinds of fees. Then we can get an effective yield in excess of 20 percent without having to disclose it.

I found that statement from an industry representative enormously cynical, but that is exactly what's happened in Maryland since this wonderful world of deregulation in the consumer credit marketplace. They used it, not to increase competition, but to decrease it.

The second thing I've seen that troubles me enormously is the advent of the open-end revolving second mortgage, and in connection with my testimony I've submitted to you one exhibit where one bank in Maryland has offered me $100,000—up to that, depending on the equity in my home—on a line of revolving credit.

Now, if I accept that, I can't imagine how I am creditworthy to any other credit grantor if I can immediately, and virtually without notice, increase my outstanding obligations by $10,000, $20,000, or $30,000.

So what may well happen is, you may see more concentration, lenders tying up a consumer with a single creditor for all of their credit needs, and the competition that we want to promote actually diminishes. We aren't far enough in yet that I can tell you that has or hasn't happened. We're going to need another year or two in Maryland. But I'm enormously worried about that and I think I'd like to see this committee worried about that.

At this point I would stop and suggest you have my comments. Those are the two particular things I wanted to bring to your attention.

[The complete statement follows:]

TESTIMONY OF
THE NATIONAL CONSUMERS' LEAGUE

REGARDING S. 2181
"FINANCIAL SERVICES COMPETITIVE EQUITY ACT"
AND S. 2134
"DEPOSITORY INSTITUTIONS HOLDING COMPANY ACT AMENDMENTS OF 1983"

BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

BY H. ROBERT ERWIN, JR., CHAIRMAN,
NCL CREDIT COMMITTEE

MARCH 7, 1984

Mr. Chairman, members of the Committee:

The National Consumers' League is pleased to have this opportunity to present our views regarding certain portions of S. 2181, "The Financial Services Competitive Equity Act," and S. 2134, "Depository Institutions Holding Company Act Amendments of 1983" on behalf of our members. The National Consumers' League is the oldest national consumer organization, founded in 1899, to bring consumer power to bear on marketplace and workplace issues. The League is a private, non-profit membership organization supported by contributions from individual members, newsletter subscribers, and various organizations including consumer groups, senior citizens' and women's groups, labor unions, and businesses. I have had the privilege of serving on the Board of Directors of the League since 1979.

By way of brief background of my own experience with consumer credit issues, I worked as a staff attorney, and then Director, at the Consumer Law Center of the Legal Aid Bureau, Inc., in Baltimore, Maryland from 1972 to 1978.

During those years I counseled and represented literally hundreds of consumers involved in a wide variety of consumer credit transactions including first and second mortgages, credit cards, retail installment purchases, auto and furniture loans, etc. In 1979 I was selected by the Maryland Attorney General, Stephen H. Sachs, to be the Chief, Consumer Protection Division, Office of the Attorney General for the State of Maryland. In that capacity I worked with other state agencies to coordinate the enforcement of various state laws regarding consumer credit, and I was actively involved with the Maryland General Assembly regarding legislative proposals to deregulate consumer credit in Maryland. On March 1, 1983 I left the Consumer Protection Division and have since been engaged in the private practice of law.

Consumer financial services have changed enormously in the past ten years, and undoubtedly the pace of that change will continue to quicken, at least for the short-term future. The traditional distinctions between various types of depository institutions such as banks, savings and loans, and credit unions have been significantly blurred, if not yet legally obliterated, not to mention the intrusion of money market funds, IRA's, and other accounts offered by new financial services institutions. While the affluent individual with significant funds to invest may welcome this new era, I suspect that the average consumer is only increasingly bewildered attempting to operate an automated teller machine to access their traditional checking or savings account.

The National Consumers' League supports the notion that a competitive marketplace with minimal government intervention provides maximum benefits to consumer and merchant alike. However, minimal government intervention will rarely equate with no government intervention since, in reality, the perfectly competitive marketplace exists only in the imagination of the economist. In today's fast-paced and technologically complex society, consumers rarely have the same extent of information about and understanding of their loan or savings account as does their bank; consumers rarely have equality of bargaining power with their bank since the amount of his or her deposit or loan is usually so small as to be insignificant; and indeed, in these days of national credit cards and loans by mail, it is difficult for consumers even to have the time to find all of the various options available to them in a national financial marketplace.

While the issues addressed in these two bills are crucial to all American consumers, it is important to keep the present debate in perspective from the consumer viewpoint. The events of the past few years which have led to these hearings today are, in reality, a battle between various financial institutions to determine who will get what size slice of the financial services pie. The critical fact we often forget is that we, the American consumers, are the pie they are fighting over. Consumer members of the National Consumers' League do not seem overly distressed that they are presently unable to purchase their houses or life insurance from their local banker, or that they cannot deposit the few dollars they save each month with their friendly, neighborhood real estate broker. As consumers, we have learned to become somewhat worried when our business friends become oversolicitous of our well-being - and especially so when our financial health is being fretted over by bankers, insurance agents or real estate brokers.

The National Consumers League concurs in the concerns others have expressed about the inherent conflicts which arise if bank holding companies also own other enterprises. Imagine the problems if a consumer puts in a contract to buy a house through a real estate broker which is affiliated with the bank to which that same consumer applies for a mortgage. Will the bank view the risk of that mortgage application differently knowing that the commission on the sale is contingent on the mortgage? Would that bank be able to resist trying to sell the required homeowners' insurance to that buyer if the bank was also affiliated with an insurance company? The National Consumers' League shares Senator Proxmire's notion that banking institutions play a vital role in allocating a scarce commodity - credit. There can be no question but that ownership of other, albeit related, enterprises will impact that allocation and that no one knows by how much.

Although we recognize the reality that the financial marketplace in which we function will be vastly different a decade from now, and that the issues before this Committee today are among the most significant in determining how that change will come about, it is precisely because we are the pie that we urge this Committee and Congress to consider these questions cautiously and carefully prior to deciding how large each slice will be. These changes in the financial marketplace need not be all detrimental to consumers and, indeed, some may well be beneficial. However, the National Consumers' League believes these changes should come about in the context of a clear and coherent national policy regarding the desirable role of financial institutions in our economy, and should be implemented cautiously so that this new marketplace can be monitored to correct abuses.

It is also important that the dense smoke of battle between the traditional despository institutions on the one hand, and insurance, real estate and security brokers on the other hand, over Titles I and X of S. 2181 not be permitted to obscure several of the other titles in that bill. The National Consumers' League strongly opposes Title VII, preempting state usury laws, and also opposes Title V, providing only minimal disclosures for consumer lease-purchase option agreements. Conversely, the League supports Title VI, providing for disclosure of deposit availability policies and, indeed, recommends that it be strengthened.

Title VII

Credit Deregulation and Availability

At the National Consumers' League annual meeting last December, our members went on record as reaffirming the League's long-standing position that we strongly oppose any federal preemption of state usury statutes. Such federal preemption is not only unnecessary but is also unwise and actually leads to less competition rather than more, as our experience with deregulation in Maryland demonstrates.

During the period 1979 through 1982 when the prime interest rate soared to record heights, it was frequently asserted that restrictive state usury ceilings made consumer lending uneconomical and led to calls for federal preemption of state usury statutes. However, both federal and state legislative action as well as more recent economic changes have dramatically altered that situation. Since 1981 more than 40 states have lifted or eliminated their interest rate ceilings. In addition, the enactment of Title VIII of D.I.D.A. in 1982 preempted state interest rate ceilings on first mortgages and home lending, deregulating a huge percentage of consumer borrowing. Of equal importance, since 1982 the prime interest rate has shown a dramatic decrease of more than 5 percentage points. Clearly, the economic pressure of the high cost of money to lending institutions requiring increases in consumer credit interest rates has changed substantially.

Advocates of deregulation frequently argue that abolishing state usury laws will increase competition to the consumer's benefit. Unfortunately, the reality is that with the exception of first mortgages and new car financing, lenders simply do not compete for more customers by lowering their interest rates. As indicated in the graph and supporting data in Attachment I, during the same two year period of 1982 and 1983 that the prime interest rate was falling from 16.6 percent to a low of 10.5 percent, both the nominal interest rate on credit cards charged by national banks and the respective effective annual percentage rate (including fees) peaked and remained stable thereafter.

Our own experience with consumer credit "deregulation" in the state of Maryland not only supports the conclusion that there is litte effective interest rate competition in the consumer credit marketplace but, in addition, it demonstrates how financial institutions actually use deregulation to make such price competition even more difficult. As some of you may recall, Maryland's neighboring state of Delaware was one of the early states to totally deregulate consumer credit in February, 1981. The Maryland financial community was quick to seize upon this as a reason for Maryland to do likewise by threatening to move their credit card operations to Delaware, and in fact doing so when the Maryland legislature did not immediately follow suit. Finally, when faced with the reality of losing jobs as well as being flooded with credit cards issued from Delaware anyway, the Maryland legislature gave in to the banking lobby. As of July 1, 1983 Mayland effectively deregulated consumer credit totally and the law now permits any interest rate agreed upon between the borrower and the lender.

Although as previously noted the prime interest rate had dropped significantly by that time, this new competition did not create a wide disparity of available interest rates. For some time prior to deregulation, the Consumer Protection Division of the Attorney General's Office of Maryland had conducted surveys of consumer credit interest rates as a public service to help consumers shop for credit. Attachment II to this testimony is the last survey we conducted before deregulation, taken as of October, 1982. Most credit card issuers were charging 18% on cash advances and on purchases were charging 18% on the first $700 and 12% on the balance above that amount. By way of comparison in a deregulated environment, First National Bank's VISA card presently charges 19.44% interest on all outstanding balances, and Hutzler's department store, for example, presently charges 21.6% interest. In sum, rather than declining as did the prime rate, interest rates actually increased following deregulation in Maryland.

Perhaps of equal significance in the long run, in addition to interest rates almost all of the associated fees have also been increased by very significant amounts. For example, virtually all of the major bankcards now require payment of an annual fee in addition to interest. Prior to deregulation, such fees were effectively prohibited on credit cards in Maryland. That the addition of such fees is particularly significant is demonstrated by the following example. During discussion of potential legislation to deregulate consumer credit in Maryland, I had occasion to meet with numerous industry representatives. One of these individuals candidly acknowledged that their market research indicated that a disclosed A.P.R. of 20% or higher would meet with significant consumer resistance. This official acknowledged that a major reason banks wished to charge annual membership fees on credit cards was to be able to have an effective yield in excess of 20% A.P.R. without being required to disclose it to consumers!

Late charges have also been added or significantly increased since deregulation, and I feel confident that it is not altogether accidental that the effect is similarly to increase the effective yield without altering the disclosed A.P.R. In addition, we have now seen variable interest rates come into existence on credit cards. Attachment III is the notice of new terms I received in September, 1983 from the First American Bank of Maryland where I have a revolving account in connection with my American Express Card. You will note that the late charge was increased while the grace period before a late charge was incurred was decreased, as well as the imposition of a variable rate of 5% above prime on the first day of the billing cycle. Attachment IV is the notice of new terms for First National Bank's VISA cards upon their move to Delaware, increasing the late charges and adding a new "overlimit charge" of $12.50 as well as a new annual membership fee.

The effect of all of this is to make it virtually impossible for a consumer to comparison shop for credit. For example, I would defy anyone to tell me how a consumer is to compare credit card A which charges a $15.00 annual fee and an interest rate of 18% on the first $1,000.00 and 12% on balances above that amount with credit card B which charges a $25.00 annual membership fee and a variable interest rate of 5% above prime on the first day of the billing cycle. Indeed, I submit to you that until we could accurately predict the future regarding exactly what purchases we would make on these accounts, when we would make them, and what the prime rate would be at any point in time in the future, such a comparison is absolutely impossible. In short, in Maryland deregulation has been implemented by the financial institutions in such a way that comparison shopping by consumers based on the price of the credit is virtually impossible. Competition has not lowered interest rates and comparison shopping is now more difficult rather than less.

Nor is this situation unique to open-end revolving credit. Prior to deregulation, the various statutes in Mayland regarding closed-end credit strictly regulated the types and amounts of the various fees which could be charged in any transaction by regulating the maximum amount of compensation lenders could receive from all sources. Following deregulation, lenders in Maryland have been free to charge any number of such associated fees and in any amount they wish. Since such fees are not necessarily required to be disclosed as part of the A.P.R. for purposes of Truth-In-Lending (eg., late charges), the proliferation of these fees makes it equally difficult for consumers to comparison shop for closed-end credit. In sum, deregulation in Maryland has virtually led to the effective repeal of Truth-In-Lending as a useful tool for consumers to comparison shop. For this reason, the National Consumers' League feels particularly strongly that the language in Section 703, Title VII of S. 2181 would effectively constitute a nationwide repeal of Truth-in-Lending.

Deregulation in Maryland has also inititated another disturbing trend that is likely to result in significantly less competition in consumer credit rather than more. I am referring to the dangerous availablity of open-ended second mortgage credit. Attachment V is my monthly statement for October, 1983 again from First American Bank of Maryland. Note that I am encouraged to "ask about our new assetline account, the convenient personal line of credit up to $100,000 for homeowners."

If I were to open such an account, and take an open-ended line of credit secured by a second mortgage in the amount of the equity I have in my home, I find it difficult to believe that I would be "credit worthy" to any subsequent credit grantor. Since I would be instantly able to increase my outstanding obligations by $5,000, $10,000, or even more, I would obviously be an enormous risk for any additional credit. It would appear to me that such open-ended second mortgage accounts will have the effect of tying customers to a single, financial institution for all of their credit needs. By enabling such accounts, deregulation is likely to further decrease competition in the consumer credit marketplace.

Finally, preemption of state usury laws removes the only weapons available to prosecuters to prevent gouging and other consumer abuse. While I was with the Attorney General's Office, an investigation by our Division uncovered a second mortgage broker who was arranging second mortgage loans to individuals at 24% interest plus 40% of the nominal loan amount as his finder's fee. This particular individual had consumers sign an "affidavit" that the loan was for business purposes, in an attempt to evade the Maryland State statutes regulating consumer transactions. The Division instituted an action against this individual based on the credit regulation statutes, alleging that these affidavits were known by both lender and broker to be a sham. Had Title VII of S. 2181 been the law of the land, this person's activities (or worse ones) would have been perfectly legal! Regardless of what we had found, neither I nor any other regulator in Maryland charged with protecting the public would have been able to do anything.

Indeed, such abuses have begun to surface in those states where deregulation of consumer interest rates has been enacted. For example, in Chicago interest rates of 48% and 50% are being charged for some used-car loans. In Arizona following deregulation, independent used-car dealers increased their prevailing interest rates by 50% - from 21.6% to approximately 31.5% - within one month. Occasional instances of Arizona used-car dealers' charging unsophisticated individuals interest rates in excess of 50% A.P.R. have been found since that state deregulated.

Surely there is some point beyond which a civilized society will not permit its citizens to be taken advantage of. The National Consumer's League sincerely hopes that this committee would not take the position that there is no amount, regardless of what deception was employed and no matter how outrageous or economically unjustified, which cannot be charged for the extension of credit. We urge that Title VII be deleted from the bill if it is reported favorably.

Title V

Consumer Leases and Rental Purchase Agreements

While the National Consumers' League certainly recognizes the magnitude of problems consumers encounter with lease-purchase options for consumer goods, the corrective approach taken by Title V of S. 2181 may do more harm than good to the consumers of many states, since it limits itself to disclosure. Again, let me call on my experiences in Maryland to provide an example.

At the Consumer Protection Division we became aware of a particular company which advertised lease-purchase agreements for televisions with "no credit check necessary" and "no down payment." Although promoted as only $19.90 per week, since payments were required for more than 18 months before the consumer acquired title to the television set, in reality consumers were paying from $1,300 to $1,550 for a television set whose retail market value when new was approximately $575. However, most of these consumers were paying between $1,300 and $1,550 to acquire title to a used television set whose fair retail value was substantiallly lower than even $575. In addition, this particular company made a frequent practice of repossessing the sets if the consumer missed only a few weekly payments, thereby keeping all monies the consumer had paid to date as "rent," and starting the period for acquiring title all over again.

This company was successfully prosecuted under the Maryland Debt Collection Statutes, but our courts ruled that this lease-purchase transaction was not covered by the existing Maryland Retail Installment Sales Act. Unfortunately, the assumptions underlying the disclosure approach of Title V contain many of the same fallacies incorporated the Court's decision - that these transactions are bone fide leases in a competitive environment. Transactions such as I have described are simply not like the long term lease purchase automobile contracts. Legislation will probably be introduced in the Maryland General Assembly to correct this and regulate such transactions. Several states have already enacted laws which regulate such transactions and define the difference between the fair market value and the total of payments as a finance charge subject to a maximum amount. Because Title V would have the effect of legitimizing such transactions as leases and discouraging the enactment of substantive regulation of such transactions in additional states, the National Consumers' League suggests that Title V be deleted.

Title VI

Fair Deposit Availability

The National Consumers' League supports enactment of Title VI, requiring disclosure of a financial institutions' policies regarding when deposits are available to their customers. Particularly with the advent of automated teller machines, the experience of finding a previous deposit unavailable is particularly frustrating.

For example, on Thursday, February 16, 1984 I deposited into my checking account my paycheck from the law firm, which was drawn on another Baltimore bank. However, on Tuesday, February 21 at 4:05 P.M. I went to an automated teller machine, made another deposit of $205.50 into my checking account but, when I tried to make a withdrawl of $30, I was told that "insufficient funds are available." My paycheck deposited the previous Thursday had apparently not yet cleared, although it was drawn on a local Baltimore bank.

Indeed, on one occasion within the last three weeks I have gone to the automated teller machine to make a withdrawal of $30 and been advised "insufficient funds are available." Having my checkbook with me on this occasion, I then entered the bank, wrote a check for $30, took it to the teller who promptly cashed it without asking any further questions. Experiences such as these do nothing but create confusion about deposit availability.

The lack of consumer information and disclosure about deposit availability again demonstrates the inadequacy of competition as an effective force in the field of financial services. It is precisely because these marketplace forces have not made such information available that states like California and New York have decided to regulate deposit availability. Similarly, the National Consumers' League would recommend a strengthening of Title VI so that it provides specific maximum periods for various categories of deposits to clear and after which the deposits would be available to the customer.

Section 14 S. 2143

Depository Institutions Holding Company Act Amendments of 1983

The National Consumers' League supports Section 14 of S. 2134, the "Depository Institutions Holding Company Act Amendments of 1983," which limits the non-banking activities of state chartered, federally insured depository institutions. Congress must act promptly to close the South Dakota loophole, and this provision is an appropriate means of doing so.

My own experience in Maryland, when our neighboring state, Delaware, deregulated convinces me that thoughtful, coherent policy regarding financial institutions cannot be set based on the least common denominator. Unfortunately, in modern society individual states are no longer sufficiently economically isolated as to be able to withstand the pressure that builds when an immediate neighbor takes significant steps towards deregulation. State legislatures cannot be "blamed" for being realistically concerned about the loss of jobs and credit from their economy, and for consequently taking some legislative steps to minimize the economic dislocation. Divide and conquer is an age-old strategy which has proven successful many times in the past, and will undoubtedly continue to be tried as long as we permit it to achieve results. Perhaps only by enacting legislation at the federal level which implements a national moratorium will we be able to stabilize the situation for a sufficient length of time to be able to formulate a coherent policy for the direction we wish financial institutions to take.

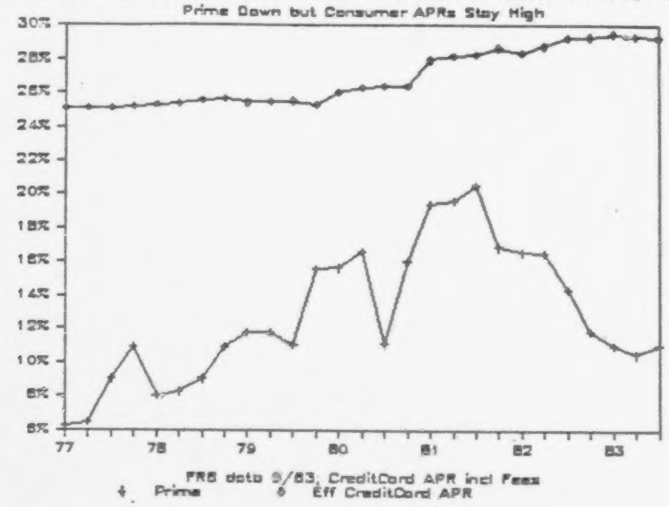
Conclusion

The National Consumers' League urges Congress to carefully and deliberately determine our policy directions prior to enacting any legislation which will permit interstate banking or authorize depository institutions to broaden their scope of available financial services. While we recognize that change is both inevitable and potentially desirable, such change should be undertaken in the context of a clear national policy and should be implemented at a measured pace so that abuses can be identified and corrected before they get out of hand. Finally, in any legislation on this subject which is reported out of this committee, the National Consumers' League strenuously urges the deletion of Titles V and VII while supporting the enactment of Title VI of S. 2181 and supports the inclusion of a provision such as Section 14 of S. 2134.

ATTACHMENT I

DEREGULATION KEEPS CONSUMER APRS HIGH

Prime Down but Consumer APRs Stay High



FRB data 9/83, CreditCard APR incl Fees

Quarterly statistics

	77				78				79				80		
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III
UsedCar APR	17.4%	17.7%	17.6%	17.8%	17.8%	17.7%	17.3%	17.9%	17.6%	17.9%	17.9%	18.4%	18.3%	18.2%	19.3%
FRB Prime	6.3%	6.4%	9.0%	10.9%	8.0%	8.3%	9.0%	10.9%	11.8%	11.8%	11.0%	15.6%	15.6%	16.6%	11.1%
CRS Bkruptcy	9.0%	9.6%	9.2%	8.7%	8.3%	9.5%	9.4%	9.9%	9.9%	11.4%	11.9%	13.9%	17.4%	21.8%	22.9%
BanK CCard	16.9%	16.9%	16.9%	16.9%	16.9%	17.0%	17.1%	17.2%	17.1%	17.1%	17.1%	16.9%	17.1%	17.3%	17.4%
xFCA fees	0.327				0.331				0.329				0.341		
=Eff APR	25.1%	25.1%	25.1%	25.2%	25.3%	25.4%	25.6%	25.7%	25.4%	25.4%	25.5%	25.3%	26.0%	26.3%	26.4%
APR >Prime	18.9%	18.7%	16.1%	14.2%	17.3%	17.1%	16.6%	14.7%	13.7%	13.7%	14.5%	9.7%	10.4%	9.7%	15.3%

		81				82				83			
	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
UsedCar APR	19.4%	19.4%	19.7%	20.4%	20.5%	20.6%	20.8%	20.9%	20.7%	19.9%	18.8%	18.3%	
FRB Prime	16.1%	19.4%	19.6%	20.5%	16.8%	16.6%	16.5%	14.4%	11.9%	11.0%	10.5%	10.9%	11.0%
CRS Bkruptcy	23.1%	23.4%	24.1%	23.7%	23.2%	22.5%	23.6%	23.5%	23.4%	21.6%	22.4%		
BanK CCard	17.4%	17.6%	17.7%	17.8%	18.0%	18.1%	18.4%	18.7%	18.8%	18.9%	18.8%	18.8%	18.8%
xFCA fees		0.370				0.360				0.36			
=Eff APR	26.4%	27.9%	28.2%	28.3%	28.7%	28.4%	28.8%	29.3%	29.3%	29.5%	29.4%	29.3%	29.3%
APR >Prime	10.4%	8.5%	8.5%	7.8%	11.8%	11.8%	12.3%	14.9%	17.5%	18.5%	18.9%	18.4%	18.3%

FRB's FinCo APRs use Feb,May,Aug,Nov, discontinued 11/82; Big 3 Auto Finco thereafter
FRB's Chart 1.34 Prime on Short Term Business Loans
Bankruptcy Rate = Personal Filing per Qtr/40.43 (=10*1976average); Congressional Research Service data
FRB's FunctionalCostAnalysis["FCA"] Adj using MediumSize CreditCard Banks' non-FinChg added Inc

ATTACHMENT II

OFFICE OF THE ATTORNEY GENERAL
CONSUMER PROTECTION DIVISION

CREDIT CARD SURVEY
October, 1982

Cards
CH - Choice
V - Visa
M/C - MasterCard
AM.EX.- American Express
CB - Carte Blanche
DC - Diners Club

Terms
Ann Fee - Annual Fee
APR - Annual Percentage Rate
MFC - Minimum Finance Charge
MMP - Minimum Monthly Payment
Method of Comp. - Method of Computation
Per Item Chg - Per Item Charge

CARD ISSUER	CARD	ANN FEE	PURCHASES						CASH ADVANCES				
MARYLAND			APR	MFC	MMP	Float (days)	Late* Fees	Method** of Comp.	APR	Per Item Chg.	MMP	Late* Fees	Method** of Comp.
Citicorp Financial, Inc. (CHOICE)	CH	-	21%	-	3%	25	-	Exc.	21%	-	3%	-	Exc.
Equitable Trust Company	V M/C		See DELAWARE — Equitable Bank of Delaware, N.A.										
Farmers & Mech. Natl. Bank Frederick	V M/C	-	18% $700; 12%	-	$10 or 5%	25	-	Exc.	18%	-	$10 or 5%	-	Exc.
Guardian Federal S/L Association	V^2	-	12%	-	-	30	-	Inc.	12%	-	-	-	Inc.
1st American	M/C	-	18% $700; 12%	-	$10 or 5%	25	-	Exc.	18%	-	$10 or 5%	15/$2 or 5%	Exc.

CREDIT CARD SURVEY

CARD ISSUER	CARD	ANN FEE	PURCHASES						CASH ADVANCES				
MARYLAND, cont'd.			APR	MPC	MMP	Float (days)	Late* Fees	Method** of Comp.	APR	Per Item Chg.	MMP	Late* Fees	Method** of Comp.
1st National Bank	V M/C		See DELAWARE — 1st Omni Bank										
Maryland National Bank	V M/C		See DELAWARE — Maryland Bank, N.A.										
Provident Savings Bank	M/C	-	18%/ $700; 12%	-	$10 or 5%	25	-	Exc.	18%/ $800; 12%	-	$10 or 5%	-	Exc.
Savings Bank of Baltimore	V M/C	-	18%/ $700; 12%	-	$10 or 5%	25	-	Exc.	18%	-	$10 or 5%	-	Exc.
Suburban Trust Company	V		See DELAWARE — Suburban Bank/Delaware										
Union Trust[1] Company	M/C	-	18.84%/	-	$10 or 5%	25	-	Exc.	18.84%	-	$10 or 5%	-	Exc.

CREDIT CARD SURVEY

CARD ISSUER	CARD	ANN FEE	PURCHASES						CASH ADVANCES				
VIRGINIA			APR	MPC	MMP	Float (days)	Late* Fees	Method** of Comp.	APR	Per Item Chg.	MMP	Late* Fees	Method** of Comp.
AAA of Md. via 1st Virginia Bank	V	-	18%	-	$10 or 5%	-	38/ 5%	Exc.	18%	-	$10 or 5%	38/ 5%	Exc.
Bank of Virginia	M/C	$15	18%	-	$10 or 5%	25	5% of past due amt	Exc.	12%+3 2% svc	-	$10 or 5%	5% of past due amt	Exc.
1st American Bank of Virginia	V M/C	-	18%	-	$25 or 5%	25	10/5% of past due amt.	Exc.	18%	-	$25 or 5%	10/5% of past due amt.	Exc.
1st Virginia Bank	V M/C	-	18%	-	$10 or 5%	-	5% of past due amt	Exc.	18%	-	5%	5% of past due amt	Exc.
United Virginia Bank	V	-	18%/ $700; 12%	-	$15/ 1/36	-	-	Inc.	18%/ $3500; 12%	-	$15/ 1/36	-	Inc.
Virginia National Bank	V M/C	$15	18%	-	$10 or 5%	30	5% of past due amt.	Exc.	12%+3 2% svc	-	$10 or 5%	5% of past due amt.	Exc.

CREDIT CARD SURVEY

CARD ISSUER	CARD	ANN FEE	PURCHASES						CASH ADVANCES				
DELAWARE			APR	MFC	MMP	Float (days)	Late* Fees	Method** of Comp.	APR	Per Item Chg.	MMP	Late* Fees	Method** of Comp.
Bank of Delaware	V	-	19.8%	.50	$20/ 1/36	25	$7	Exc.	19.8%	-	$20/ 1/36	-	Exc.
Delaware Trust	V M/C	-	18%	.50	$10 or 5%	25	5%	Exc.	18%	-	$10 or 5%	5%	Exc.
Equitable Bank of Delaware, N.A.	V M/C	$18[17]	19.8%	-	$10 or 5%	25	$5	Inc.	19.8%	-	$10 or 5%	$5	Inc.
1st Omni Bank	V M/C	$18[4]	19.44%	-	$10 or 5%	25	30/ $12.50	Inc.	19.44%	-	$10 or 5%	30/ $12.50	Inc.
Girard Bank	V M/C	$15	18%	.50	$5 or 5%	25	$5/ 5%	Exc.	18%	-	$5 or 5%	$5/ 5%	Exc.
Maryland Bank, N.A.	V M/C	$18	18.9%		$15 or 4%	25	20/ $5	Inc.	18.9%	-	$15 or 4%	20/ $5.00	Inc.
Suburban Bank/ Delaware	V	$18	17.9%	-	$10 or 5%	25	30/ $10	Inc.	17.9%	-	$10 or 5%	30/ $10	Exc.

CREDIT CARD SURVEY

CARD ISSUER	CARD	ANN FEE	PURCHASES						CASH ADVANCES				
DELAWARE, cont'd.			APR	MFC	MMP	Float (days)	Late* Fees	Method** of Comp.	APR	Per Item Chg.	MMP	Late* Fees	Method** of Comp.
Wilmington Trust	V M/C	-	18%	-	$10/ or 1/36	25	-	Exc.	18%	-	$10/ or 1/36	-	Exc.
PENNSYLVANIA													
Fidelity Bank via Hagerstown Trust	M/C	-	18%	.70 if over $5	$10 or 1/25	-	-	Exc.	19.8%	-	$10 or 1/25	-	Inc.
NEW YORK			APR	MFC	MMP	(days)	Fees	Comp.	APR	Chg.	MMP	Fees	Comp.
Chase Manhattan Bank, N.A.	V	$15	18%	.50	$10 or 1/36	25	-	Inc.	18%	-	$10 or 1/36	-	Exc.
Citibank (South Dakota), N.A.	V M/C	$20	19.8%	.50	1/36 of highest balance	25	25/$5 95/$10	Inc.	19.8%	2%/ $2 min. $10 max.	-	25/$5 95/$10	Inc.

CREDIT CARD SURVEY

CARD ISSUER	CARD	ANN FEE	PURCHASES						CASH ADVANCES					
NEW YORK, cont'd.			APR	MFC	MMP	Float (days)	Late* Fees	Method** of Comp.	APR	Per Item Chg.	MMP	Late* Fees	Method** of Comp.
Manufacturers Hanover	V M/C	$15	19.8%	.50	$10 or 1/36	25	-	Exc.	19.8%	-	$10 or 1/36	4¢ per$ $5 mth max $15 ann max	Exc.
National Bank of North America (New York)	V	$15[7]	19%	.50	$5 or 1/36	25	-	Exc.	19%	.25	$5 or 1/36	10/4¢ per $: $15 max	Exc.
CALIFORNIA													
Bank of America	V	$12	19.0%	-	$10/ $250; 4%	25	5%/ $5 max.	Exc.	19.8%	-	$10/ $250; 4%	5%/ $5 max	Exc.

CREDIT CARD SURVEY

CARD ISSUER	CARD	ANN FEE	PURCHASES						CASH ADVANCES				
ILLINOIS			APR	MFC	MMP	Float (days)	Late* Fees	Method** of Comp.	APR	Per Item Chg.	MMP	Late* Fees	Method** of Comp.
Continental Illinois National	V M/C	$15	19.8%	-	$10[8] or 5%	-	-	Exc.	19.8%	-	$10[8] or 5%	-	Exc.
First National Bank of Chicago	V M/C	$20	19.8%	-	$10 or 5%	-	-	Exc.	19.8%	-	$10 or 5%	-	Exc.
TRAVEL AND ENTERTAINMENT CARDS[9]													
American Express[9]	AM.EX.	$35	-	-	Full	-	2-1/2%[10]	-	18%	-	$10 or 5%	15/$2 or 5%	Exc.
Carte Blanche	CB	$35	-	-	Full	-	2-1/2%[11]	-	19.8%[12]	-	$10 or 1/24	4%/$5; $15 max	-
Diner's Club	DC	$40	-	-	Full	-	2-1/2%[13]	-	-	-	-	-	-

OIL COMPANIES

CARD ISSUER	APR	MMP	Float (days)	Late Fees	Method of Comp.
CROWN	-	Full	28-32 days	1.5%/$700; 1.0%	Exc.
EXXON	_	Full	-	1.75%	Past Due Balance
GULF	Refused Response	Refused Response	Refused Response	Refused Response	Refused Response
MOBIL	-	Full	30 days	60/1.75%	Inc.
SHELL	18%/$700; 12%	$35	25 days	-	Exc.
SUNOCO	Refused Response	Refused Response	Refused Response	Refused Response	Refused Response
TEXACO	-	Full	25 days	1.75%	Exc.

CREDIT CARD SURVEY

DEPARTMENT STORES

CARD ISSUER	APR	MFC	MMP	Float Days	Method of Comp.
Bambergers	21.6%	-	$15 to $20	25	Exc.
Bloomingdales	21.6%	-	$20-$100; over $100/ 20%	27 days	Inc.
Eyerly's	21.0%	-	-	30	Exc.
Garfinkles	No Response	No Response	No Response	No Response	No Response
Hecht Company	21.6%	-	$20	61 days	Exc.
Hochschild Kohn	No Response	No Response	No Response	No Response	No Response
Hutzler's	18%	-	$10 or 25%	25	Inc.
I. Magnin	18%/$500; 12%	-	$25	25	Inc.

DEPARTMENT STORES

CARD ISSUER	APR	MFC	MHP	Float Days	Method of Comp.
J. C. Penny Co.	21.0%	-	\$10-\$40;[16] 1/10 over \$500.	28-59 days	Exc.
Leggett	18%/\$700; 12%	-	\$10	25	Exc.
Lord and Taylor	18%/\$700; 12%	-	20%	25	Exc.
Montgomery Ward	21.6%	-	\$15	59 days max.	Exc.
Raleigh Stores[15] (Preferred Shopper)	18%	-	\$20	25	Ending Adj. Bal.
Rouzahn's	20.5%	-	10%	25	Inc.
Sears, Roebuck	21%	No Response	No Response	No Response	No Response
Stewart & Co.	21%	-		25 days	Exc.
Woodward & Lothrop	21.6%	-	15%	25	Exc.
Zayres	21.6%	-	10%	25 days	Exc.

CODES

CREDIT CARD SURVEY

1. Cardholder is required to maintain a 5 1/4% account at Union Trust with a minimum monthly balance of between $300.00 and $1,000.00 depending upon type of account.

2. Minimum $1000 required in savings account paying 5-1/2%.

3. 2% Service charge on amount advanced plus 12% annual finance charge. The application of these charges results in an APR of 36% in the month that the cash advance is made.

4. The fee is $18 when the consumer has one card, and $21 when he has both cards.

5. Variable rate is available.

6. Recognized by selected retailers in D.C., MD., VA., and Del.

7. May be waived for consumers who open a personal checking account or NOW account.

8. $10 or 5% up to $1000; 4% $1,000-$2,000; 3.3% over $2,000.

9. American Express "Gold Card" annual fee is $50, with extended payment plan option charging 18% APR.

10. 2-1/2% Per month or $10 on amounts over $50 for outstanding charges remaining unpaid thirty days after the billing date. Any delinquency of 60 days or more is charged 2 1/2% of total amount over 30 days delinquent.

11. Charge assessed on amounts past due for 2 consecutive billing cycles. A one-time $10.00 charge is also assessed on any amounts past due for 3 cycles.

12. Line of credit available through Citibank, N.A.

13. 2-1/2% on any amount past due for 2 or more consecutive billing cycles.

14. $0 to $35.00, payment in full; $35.01 to $200.00, $35; $200.01 to $300.00, $45; Over $300.00, $45 plus amount in excess of $300.00.

15. Each member store of the Preferred Shopper Association establishes its own terms.

16. If you use the Time Payment Charge, check your agreement.

17. Fee is waived if consumer maintains a $300 balance in a savings account paying 5-1/4%.

* The first number indicates the number of days before which a set late fee or a percentage penalty is charged.

** "Inc." = Average daily balance inclusive of unpaid previous finance charges
"Exc." = Average daily balance exclusive of unpaid previous finance charges

ATTACHMENT III

1stAMERICAN
FIRST AMERICAN BANK OF MARYLAND

CHANGE IN TERMS NOTICE

September 29, 1983

Dear Exec-U-Check Customer:

As a valued customer, you understand the importance of the convenience of having access to your preapproved Exec-U-Check funds when and where *you* need them. As you know, interest rates have been volatile over the past several years. In an effort to charge you a fair market rate of interest on your outstanding balances, the rate will be indexed to the published prime rate and will float with the market. This letter describes changes to your Exec-U-Check account and includes a review outlining the sections of your contract that are being changed. These changes will be made in accordance with the terms and conditions of your existing Exec-U-Check contract with the Bank and in accordance with Article 12-901 *et seq* of the Commercial Law Title of the Annotated Laws of Maryland (effective July 1, 1983), and with other applicable law.

Effective **October 14, 1983**, your Exec-U-Check account will be subject to the following changes:

- The ANNUAL PERCENTAGE RATES used to calculate FINANCE CHARGES will be changed;
- Late Charges will be changed;
- Any amendments to your Exec-U-Check account, including amendments described in this notice, will apply to all of the outstanding unpaid indebtedness in your account on the effective date of the amendment;
- Credit Life Insurance will be changed;
- Your account will be subject to Article 12-901 *et seq* of the Commercial Law Title of the Annotated Laws of Maryland; and
- Your billing cycle date is being changed.

FINANCE CHARGES

Existing Terms

If your monthly payment is debited automatically from your checking account, the FINANCE CHARGE is currently at a daily periodic rate of 0.048630% simple interest per day on the average daily balance and the insurance premium (17.75% (automatically debited) ANNUAL PERCENTAGE RATE). If your monthly payment is not debited automatically from your checking account, the FINANCE CHARGE is at a daily periodic rate of 0.054520% simple interest per day on the average daily balance and the insurance premium (19.9% (not automatically debited) ANNUAL PERCENTAGE RATE).

New Terms

FINANCE CHARGES will be imposed monthly upon the Average Daily Balance which is computed by adding together each day's ending loan balance during the billing period and dividing the result by the number of days in the billing period, and upon the credit life insurance premium, if applicable. The FINANCE CHARGE will be calculated by multiplying the number of days in the monthly billing period times the Average Daily Balance times the Daily Periodic Rate in effect during such monthly billing period.

The Daily Periodic Rate and corresponding ANNUAL PERCENTAGE RATE will increase and decrease as the Prime Rate (as defined below) in effect on the first day of each billing cycle increases and decreases. In this way, the ANNUAL PERCENTAGE RATE may not increase more often than once a month and will always be five percentage points (5%) above the Prime Rate (unless a substitute index is used as described below). For example, if the Prime Rate (as defined below) was 10% on the first day of a certain billing cycle, the Daily Periodic Rate for that monthly billing period would be 0.041095%, and the corresponding ANNUAL PERCENTAGE RATE would be 15% (5% above the Prime Rate.) In no event however, will the ANNUAL PERCENTAGE RATE be less than 10%. Each increase and decrease will be applicable to your entire Exec-U-Check account balance on and after the effective date of the increase or decrease, and will have the effect of increasing or decreasing your monthly Payment Amount Due. "Prime Rate" means, as of any date, the per annum rate most recently reported prior to such date as the prime rate in *The Wall Street Journal* in its compilation of key United States and foreign annual interest rates. If more than one prime rate shall be reported, the highest rate reported shall be the Prime Rate. The current Prime Rate is available to you and verifiable by you at any of our offices. In the event that the reporting of the Prime Rate is discontinued or substantially altered, we may, at our option, choose another index made readily available to and verifiable by you and beyond our control. If this happens, the substitute index will, for the purposes of this Agreement, be considered to be the "Prime Rate," although it may be necessary to adjust the number of percentage points above the substituted index in determining the ANNUAL PERCENTAGE RATE.

LATE CHARGES

Existing Terms

You currently have to pay a Late Charge of the greater of $2.00 or 5% of the minimum payment if that amount remains unpaid for more than 15 days after the due date.

New Terms

You will have to pay the greater of $10.00 or 5% of the minimum monthly payment if that amount remains unpaid for more than 10 days after the due date.

AMENDMENTS

Existing Terms

The Bank can now change the terms of the Agreement governing your account at any time in accordance with applicable law.

New Terms

The Bank will continue to be able to change the terms of the Agreement governing your account at any time in accordance with applicable law. In addition, any amendment to the Agreement described in this Notice or any future notice, which you accept (including but not limited to amendments affecting FINANCE CHARGES, other charges or repayment) shall apply to all of the outstanding unpaid indebtedness in your account on the effective date of the amendment, including any indebtedness which shall have arisen out of cash advanced to you prior to the effective date of the amendment.

8910 Route 108, P.O. Box 2321, Columbia, Maryland 21045, Telephone (301) 992-4422

CREDIT LIFE INSURANCE

Existing Terms

Optional Credit Life Insurance is now available to the principal account holder at the cost of $.83-1/3 per $1,000.00 of the Average Daily Balance outstanding per billing period if the principal account holder qualifies for the insurance. Such insurance is currently provided under Group Policy No. 20-061 and Sub-codes of the Stuyvesant Life Insurance Company, 105 Hamilton Street, Allentown, PA 18101. The policy is available only if the account holder is under 66 years of age on the date the coverage is issued. Coverage is for the amount necessary to discharge the indebtedness of the account holder to the Bank under the Exec-U-Check Plan Agreement, but if such person is insured under such Group Policy with respect to more than one indebtedness, coverage is limited to a total amount of $5,000.00. Coverage automatically terminates on the happening of any of the following events: (a) the date any payment due the Bank becomes six months overdue, (b) the termination of the Exec-U-Check Plan Agreement, (c) the date of termination of the policy, (d) the date of expiration of 24 consecutive months during which period no unpaid balance exists in the insured's account, (e) at the end of the month in which the insured attains his or her 66th birthday.

New Terms

Optional Credit Life Insurance will be available under one group policy with the Omaha Financial Insurance Company, St. Paul, Minnesota, to both the principal account holder and joint account holder (if spouse of the principal account holder) who have not reached their 66th birthday. The cost of the insurance will be $.87 per $1,000.00 of the Average Daily Balance outstanding per billing period for single coverage or (if joint coverage is available), $1.45 per $1,000.00 of the Average Daily Balance outstanding per billing period for joint coverage. If you purchase insurance, the cost will be paid by you each month as an additional charge (itemized in your monthly statement). Coverage will be for the principal balance of your Exec-U-Check account, but will not exceed a $25,000 total for your line of credit balance and all of your other debts to us. If you choose joint coverage, benefits will be payable only with respect to the first to die.

All insurance benefits are payable to us and will be applied against your indebtedness. If benefits are more than the balance of your debt, the difference will be paid to a second beneficiary, if any, or to your estate. If you have already purchased credit life insurance and are subject to the "existing terms" described above, you will automatically be subject to the "new terms" described herein upon use of your Exec-U-Check account on or after **October 14, 1983.** Insurance coverage will stop when the agreement governing your policy is terminated and your Exec-U-Check account is paid off, at the end of the month for which you paid your last premium, when the group policy is terminated (subject to 31 days written notice), or on the last date of the month during which you reach age 70, whichever happens first. If you are not covered and choose to purchase insurance under our group policy, please contact us.

GOVERNING LAW

Existing Terms

Your account is currently governed by Article 12-101 *et seq* of the Commercial Law Title of the Annotated Laws of Maryland.

New Terms

If you agree to be bound by the new terms described in this notice by using your Exec-U-Check account on or after **October 14, 1983,** your account will be governed by Article 12-901 *et seq* of the Commercial Law Title of the Annotated Laws of Maryland (effective July 1, 1983).

Enclosed is an amended version of the Exec-U-Check Plan Agreement and Disclosure Statement (for your records) changed to include a full description of the changes described above.

Use of your Exec-U-Check account on or after October 14, 1983 will constitute your agreement to be bound by the new terms described in this notice, and all unpaid balances existing in your account on October 14, 1983 will be subject to the new terms. If you do not wish to be bound by the new terms described in this notice, you must discontinue use of your account before October 14, 1983, and repay what you owe us under the existing terms described in this notice.

BILLING CYCLE CHANGE

We will be instituting an additional change that will affect ALL Exec-U-Check customers regardless of whether or not you use your Exec-U-Check account on or after October 14, 1983. This change concerns your billing cycle date. For the month of October, 1983, those of you who would normally be billed on the 15th of October will not be billed until the 25th of October and you will have 20 days before your payment is due (November 15th). Your next billing will be November 25th (payment due date December 15th). Those of you who would normally be billed on the 31st of October will not be billed until the 25th of November and you will have 20 days before your payment is due (December 15th). Thereafter all accounts will be billed on or near the 25th of the month and will be due on or near the 15th of the following month.

Thank you for the privilege of being able to serve you. If you have any questions regarding these changes, please call us on: Local (301)-596-1129 or Long Distance 1-(800) 352-1443.

Sincerely,

Enclosures

ATTACHMENT IV

First Omni Bank
N.A.
POST OFFICE BOX 800 MILLSBORO, DELAWARE 19966

May 7, 1982

Notice of Change in Terms

IMPORTANT—READ CAREFULLY

First Omni Bank, National Association is changing certain terms relating to your account (your "Account"). This is a notice of those changes. If you use your VISA Card, MasterCard Card, Charg-Cheks or Xtra-Cheks bearing the name of The First National Bank of Maryland or First Omni Bank (jointly referred to in this Notice as your "Card") issued to you in connection with your Account to make a purchase or obtain a loan (cash advance), or create an overdraft on your checking account, on or after May 25, 1982, the terms of your Account agreement with First Omni Bank will change and you will be deemed to have accepted the new terms described in this Notice and the new Deposit Account and Card Services Agreement enclosed with this Notice, and they will then become effective as to you. If you do not use your Card, or create an overdraft on your checking account, on or after May 25, 1982, your Account will be governed by the agreement you entered into with The First National Bank of Maryland and you will be permitted to pay the outstanding unpaid indebtedness on your Account in accordance with the terms of the agreement now governing your Account without giving effect to the changes described in this Notice. If you do not want to accept the new terms and agreement, do not use your Card, or create an overdraft on your checking account, on or after May 25, 1982.

If you accept the new terms and agreement, they will apply to your entire sales balance as of the first day of the billing period following the billing period during which you accepted the new terms and agreement, and they will apply to your entire loan balance on the day you accepted the new terms and agreement.

Your Card bearing the name of The First National Bank of Maryland is now a First Omni Bank Card and you may continue to use it. Prior to its expiration date, you will be issued a new Card bearing the name of First Omni Bank.

The following is a summary of changes which will be accepted by you if you use your Card or create an overdraft on your checking account on or after May 25, 1982.

Summary of Changes

(1) Governing Law	Your Account will be governed by the laws of the State of Delaware in place of Maryland law.
(2) FINANCE CHARGE	The rate of **FINANCE CHARGE** will be increased. On sales, the monthly periodic rate will be increased to **1.62%** (corresponding **ANNUAL PERCENTAGE RATE** of **19.44%**). We will no longer charge different **FINANCE CHARGE** rates on ranges of purchase balances. On loans, the daily periodic rate will be increased to **.05326%** (corresponding **ANNUAL PERCENTAGE RATE** of **19.44%**). An **ANNUAL PERCENTAGE RATE** of **19.44%** will apply to purchases and loans. Prior to the change in terms, on sales, the monthly periodic rate was **1.5%** (corresponding **ANNUAL PERCENTAGE RATE** of **18%**) on the first $700 of the Average Daily Sales Balance and **1%** (corresponding **ANNUAL PERCENTAGE RATE** of **12%**) on the Average Daily Sales Balance over $700, and on loans, the daily periodic rate was **.0491%** (corresponding **ANNUAL PERCENTAGE RATE** of **18%**).
(3) When Purchases Are Subject To FINANCE CHARGE	You will avoid additional **FINANCE CHARGE** on the sales balance portion of the New Balance shown on your periodic statement if that portion is paid in full by the Payment Due Date set forth on that statement.
(4) How FINANCE CHARGE Is Calculated	We still use the Average Daily Balance method to compute **FINANCE CHARGE**. However, the way we calculate the Average Daily Sales Balance and the Average Daily Loan Balance will change. On a monthly basis, unpaid **FINANCE CHARGES** and other unpaid charges (such as late charges, overlimit charges and fees for obtaining copies of documents) will now be added to your Account balance, and **FINANCE CHARGES** will be computed thereon. A result of this change is that **FINANCE CHARGES** will now be compounded and **FINANCE CHARGES** will be charged on unpaid charges. A more detailed description on this change is set forth in (a) and (b) below.

over

(a) FINANCE CHARGE On Sales Balance

FINANCE CHARGE on the sales balance portion of the New Balance shown on your periodic statement will be calculated in this way: (a) we start with your previous sales balance at the beginning of the billing period (for this purpose, your previous sales balance includes unpaid **FINANCE CHARGES** on purchases and other unpaid charges relating to the sales balance portion of your Account from previous billing periods); (b) each day of the period we subtract payments and credits from, and add new purchases to, the previous sales balance (new purchases are added from the date of transaction and, on the closing date of the current billing period, we add late charges, overlimit charges and other charges imposed, but we do not add the **FINANCE CHARGE** for the current billing period), giving us the daily sales balance; (c) we then divide the sum of the daily sales balances by the number of days in the billing period and multiply this average (called the "Average Daily Sales Balance") by the applicable monthly periodic rate, which is **1.62%** (Corresponding **ANNUAL PERCENTAGE RATE** of **19.44%**).

(b) FINANCE CHARGE On Loan Balance

FINANCE CHARGE on loans will be calculated in this way: (a) we start with your previous loan balance at the beginning of the billing period (for this purpose, your previous loan balance includes unpaid **FINANCE CHARGES** on loans and, if not included in your previous sales balance for purposes of calculating **FINANCE CHARGE**, other unpaid charges relating to your loan account from previous billing periods); (b) each day of the period we subtract payments and credits from, and add new loans to, the previous loan balance (new loans are added on the day the loan is made and, if not added to your new purchases, on the closing date of the current billing period, we add late charges, overlimit charges and other charges imposed, but we do not add the **FINANCE CHARGE** for the current billing period), giving us the daily loan balance; (c) we then add the daily loan balances outstanding each day during the billing period and divide the result by the number of days any loan is outstanding during the billing period, giving us the "Average Daily Loan Balance;" (d) we then multiply the Average Daily Loan Balance by the daily periodic rate of **.05326%** (Corresponding **ANNUAL PERCENTAGE RATE** of **19.44%**), and multiply that total by the number of days that any loan is outstanding during the billing period.

(5) ANNUAL SERVICE CHARGE

(a) If your Account is a CardSavings Account, there is still no annual service charge for your card.

(b) If your Account is a Credit Card Account, we will now charge you an annual service charge for the privileges made available to you under your Account. If you are issued either a VISA Card or a MasterCard Card, the annual service charge will be $18.00. If you are issued both a VISA Card and a MasterCard Card, the annual service charge will be $21.00. Annual service charges will be charged on a calendar year basis for each full calendar year, or portion thereof, that a valid Card is outstanding, will be non-refundable and will not be prorated. There was previously no annual service charge.

(6) LATE CHARGE

If you are delinquent for 30 days or more in the payment of the Minimum Payment Due set forth on your periodic statement, we shall have the option of charging a late charge of $12.50. Prior to the change in terms, if you did not pay the Minimum Payment Due within 15 days after a Payment Due Date, we could charge a late charge of the greater of $2 or 5% of your total delinquent payment.

(7) OVERLIMIT CHARGE

If you exceed your credit limit, we shall have the option of charging an overlimit charge of $12.50. There was previously no overlimit charge. A late charge and an overlimit charge will not be imposed during the same billing period.

1st AMERICAN
FIRST AMERICAN BANK OF MARYLAND
MEMBER FDIC

ATTACHMENT V

MONEY EXCHANGE

PLEASE NOTIFY US OF ANY CHANGE OF ADDRESS

H ROBERT ERWIN JR
5008 FOREST PARK AVE
BALTIMORE MD 21207

---- TOWSON 321-4200
CUSTOMER INFORMATION SERVICE:
COLUMBIA AREA: 596-1111
ELSEWHERE IN MD: 800-492-2808
---- ---- SOC SEC / TAX ID:
ACCOUNT NUMBER:
ITEMS: 1 ENCLOSURES: 0
DATE: 10/25/83 PAGE: 1

EXEC-U-CHECK

DATE	DESCRIPTION	REFERENCE NO	AMOUNT	BALANCE
SEP 15	PREVIOUS BALANCE			.00
OCT 21	CREDIT LINE ADVANCE	40021531	750.00+	750.00
OCT 25	FINANCE CHARGE		1.64+	751.64
OCT 25	NEW BALANCE			751.64

SUMMARY

CLOSING DATE: 10/25/83 DAYS IN BILLING CYCLE: 40

PREVIOUS BALANCE	+	ADVANCES / FEES	+	FINANCE CHARGE	+	LIFE INSURANCE	-	PAYMENTS	=	NEW BALANCE
.00		750.00		1.64		.00		.00		751.64

AVG DAILY BALANCE	DAILY RATE (VARIABLE)	ANNUAL PCT RATE (VARIABLE)	CREDIT LIFE INS.	AVAILABLE CREDIT
93.75	.043835	16.00	.000	1,248.36

ACCOUNT NUMBER	PAYMENT DUE DATE	PAYMENT AMOUNT DUE
	11/14/83	26.64

ASK ABOUT OUR NEW ASSETLINE ACCOUNT. THE CONVENIENT PERSONAL LINE OF CREDIT UP TO $100,000 FOR HOMEOWNERS

NOTICE: SEE REVERSE SIDE FOR IMPORTANT INFORMATION

The **Chairman**. Your full statement will be included in the record. We will have additional comments.

I just want to make one quick comment and then we are going to have to go or miss the vote.

I agree with your general comments about many of the forgotten people in this equation and, if you listen to the testimony, everybody is in here promoting what they think their testimony is in favor of their position. Deregulation is not a panacea and if you were here this morning you heard me say that if we could go back far enough to where I still had hair we would find everybody nice, neat, and compartmentalized and that would be my preference. But you can't put the genie back in the box.

So the question I think this committee has to answer is, deregulation is going on in the marketplace and that's why I think we have to try and come to grips with some of these things, not deregulation for deregulation's sake or because somebody wants a piece of somebody else's market. They are doing that and I think ultimately the consumer will benefit more if we set a national policy, whatever that ends up being, rather than allow all these aberrations to go on like South Dakota and all the other things.

Mr. **Erwin**. But the second part of that, Mr. Chairman, is as you do it, monitor it. Don't do it and walk away from it and don't leave it to others to monitor. If this committee and this Congress is going to do that, stay on top of it. Stay on top of it for a number of years afterwards, and be sure that the kinds of abuses that are in some of these crystal balls don't come about.

The **Chairman**. I agree. Gentlemen, thank you very much. We appreciate your testimony.

Senator **Sarbanes**. Mr. Chairman, I want to thank the witnesses for their statements. I had a chance to look through them. Obviously a great deal of work has gone into them and I think it's very helpful to the committee if in fact we do read them.

The **Chairman**. The committee is adjourned.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

WRITTEN STATEMENT OF

JOHN N. REARDON

on behalf of

THE ASSOCIATION OF DATA PROCESSING SERVICE ORGANIZATIONS, INC.

ON

S. 2134 and S. 2181

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

March 7, 1984

Mr. Chairman and Members of the Committee:

My name is John N. Reardon. I am President of USERS, INC., a Valley Forge, Pennsylvania firm providing batch, on-line and in-house data processing services to over 400 credit unions throughout the United States. I am submitting this testimony on behalf of the Association of Data Processing Service Organizations, Inc., and its Financial Services Industry Committee which I chair.

I wish to thank the Committee for this opportunity to submit this testimony and to express the views of ADAPSO on several critical matters involved in your timely scrutiny of conditions in the financial services industry. An active member of ADAPSO, USERS, INC. joins in the Association's views.

ADAPSO is the principal trade association of this nation's computer services industry. Its members provide the public with an enormous range of practical services, predominantly financial and economic in nature, through a variety of computer service techniques. These techniques include local batch processing; the provision of computer software for large, mainframe computers and software for small business and home computers; software design and consulting; facilities management arrangements; and remote access data processing and information retrieval. In 1982, ADAPSO's 600-plus members accounted for more than half of the industry's $25 billion in revenues.

USERS, INC., like the preponderance of ADAPSO's membership, is an active and critically important participant in the delivery of banking and financial services to the consumer. We are the specialists who make innovative computer technology available to this nation's depository institutions. As such, ADAPSO members and USERS, INC. are directly affected by the work of this distinguished Committee, especially where your efforts lead to restructuring and deregulation of banking institutions through S. 2134 and S. 2181. In the limited amount of time available to me today, I would like to touch briefly upon three points of considerable interest to the computer services industry. I will summarize these points at the outset.

Our first point is that data processing per se is simply a technology which can be applied to perform virtually unlimited kinds of services ranging from financial services such as accounts payable and receivable reporting to orange crop prediction in the state of Florida. Accordingly, if the Congress wishes to permit depository institutions entry into the data processing business, Congress should define that business in terms of those services which depository institutions may offer to the public through data processing. Otherwise, Congressional authorization of unspecified "data processing" as a permissible activity for depository institutions will include the authority to offer purely commercial data processing services which are totally unrelated to banking or finance.

My second point is that the holding company subsidiary is an essential vehicle for any expansion of the permitted product and service activities of depository institutions. The strident and conflicting views of interested parties will be effectively dealt with if depository institutions are permitted to engage in an expanded range of financial activities only through a subsidiary which is rigidly separated from the depository institution itself. Such structural separation of the banking and nonbanking activities of banks, savings-and-loans and savings banks would not meaningfully impair the competitiveness of such institutions with non-depository, financial organizations. Moreover, depositors' funds would be insulated from the risks and rigors of the competitive activities of depository institutions. In addition, the competitive affiliates of depository institutions would be far less able to exploit the unfair competitive advantages that flow from unrestrained relationships with depository institutions having credit-granting franchises. The key to the holding company subsidiary as a promising solution to the various dilemmas of asset deregulation, however, turns on the quality and quantum of separation between a depository institution and its competitive affiliates.

My third point is basically a plea to this Committee to investigate in depth the entry of the Federal Reserve System into the data processing and data transmission business. At this time, the Federal Reserve is well along in its campaign to compete with private sector providers of electronic payment services. The Federal Reserve is competing with computer service firms and depository institutions alike, without specific Congressional authorization. We question whether this activity is necessary, proper and , to this point, fairly priced. We fear that continued Federal Reserve competition will deter entry by private sector firms into the electronic payment services marketplace, or will drive them out altogether. The proper role of the Federal Reserve is a critical part of any analysis of the conditions of the financial services industry.

"Data Processing" by Depository Institutions

I turn now to my first point which deals with the proposed expansion of depository institution powers to include "data processing" authority. Both banking organizations and federal banking regulators have pressed for Congressional allowance to depository institutions to engage in unspecified "data processing" activities.[1] In fact, previous draft versions of the Bank Holding Company Deregulation Act, introduced as S. 2490 and H.R. 6762, included "data processing" as a permissible activity for subsidiaries of bank holding companies.

The problem with this approach is that it contains no definition of permissible "data processing," much less that comports with the reality of the data processing marketplace. "Data processing" is by definition a neutral computer technology which can be and has been employed to automate virtually every business discipline or function. As a technology, "data processing" can never be inherently banking or even financial in nature.

"Data processing" can be characterized as a financial or non-financial activity only after analysis of the particular service to be performed using data processing technology. In fact, a firm cannot "process" data unless the data is being processed for a particular purpose or with a certain end service in mind. Our customers do not contract for the random processing of data; rather, they seek specific business services such as payroll preparation, Regulation E compliance, loan accounting, cash management, and so on.

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[1] See, e.g., Financial Institutions Restructuring and Services Act of 1981, Hearings on S. 1686 et al., Before the Senate Committee on Banking, Housing and Urban Affairs, 97th Cong. 1st Sess. (1981), at 433 (statement of Paul Volcker, Chairman Board of Governors, Federal Reserve System); Written Statement of William M. Isaac, Chairman, Federal Deposit Insurance Corporation, Hearings on the Conditions of the Domestic Financial Services Industry Before the Senate Committee on Banking, Housing and Urban Affairs, 98th Cong., 1st Sess., at 7 (April 27, 1983).

Any blanket authorization to engage in undefined "data processing" activities carries with it the authorization to offer any service which can be performed through "data processing." "Data processing" as a technology can be applied to perform a virtually unlimited array of services which can include demand deposit accounting but also race track handicapping, business forecasting, marketing analysis, inventory control or site selection for a MacDonald's franchise. As a result, if Congress permits depository institutions to engage in "data processing" activities without limiting the nature of the services to be furnished, Congress will have blindly authorized the provision of services (through data processing) having no relation whatsoever to banking or finance.

This result cannot be intended even by the most ardent advocate of expansion of depository institution powers. This result conflicts with the current, longstanding federal prohibition on the extension of banking into general commerce — a prohibition which all seemingly agree is still valid.

To avoid depository institution diversification into non-financial, commercial data processing endeavors, Congress should analyze the nature of the services to be performed through data processing technology. If there is a legitimate and pressing need for depository institutions to offer financial data processing services, Congress should specify those financial services which depository institutions may provide without breaching the wall between banking and commerce.

In our view, depository institutions should not be permitted to offer to the public purely economic data processing services including catalogue shopping, business planning, product analysis, economic data base services and general ledger services. It is also our position that depository institutions should not be permitted to offer to the public general purpose data processing services which permit unlimited, non-financial applications.

These general purpose services include the provision of raw computer power (e.g., computer timesharing services) to customers so that they can engage in whatever data processing functions they choose. Also impermissible should be the provision of computer access to or purchase of general modelling, analytical and forecasting software programs which enable the customer to engage in unrestricted, non-financial functions. These services are called "general purpose" because, by design and in response to the marketplace, they furnish highly flexible data processing technology to the customer so that the customer can employ this technology to arrive at solutions and services limited only by the particular, changing needs of the customer.

Economic and general purpose data processing services have no relation to banking or finance; these are strictly commercial data processing services. A grant of authority to depository institutions to engage in such services or to engage generally in unspecified "data processing" activities would make a mockery of the federal policy separating banking from commerce. Whether such a grant of authority is legal under the current Bank Holding Company Act is directly at issue in the fully submitted ADAPSO litigation against the Board of Governors of the Federal Reserve System.[2] We are awaiting a decision by the U.S. Court of Appeals for the District of Columbia Circuit.

Let me make our position clear before moving on to my second point today. ADAPSO does not seek to deny the benefits or use of data processing technology to depository institutions in the performance of the banking activities authorized by their charters. We do not seek a federal ban on all data processing activities by depository institutions nor are we seeking a blanket prohibition on the offering to the public by any depository institutions of services which are provided by means of the application of data processing technology. ADAPSO's position focuses on the definition of those services which depository institutions should be permitted to offer to the public through data processing technology without violating the federal prohibition on commercial endeavors by banking organizations. In our view, the public offering of economic and general purpose data processing services by depository institutions should be prohibited in light of current federal policy. In addition, the public offering of undefined "data processing" by depository institutions should be prohibited for similar reasons.

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[2] ADAPSO, et al. v. Board of Governors of the Federal Reserve System, Nos. 82-1910, 82-2108 (D.C. Cir., oral argument conducted April 26, 1983); see also ADAPSO et al. v. Comptroller of the Currency, et al., 77 Civ. 2574 (S.D.N.Y., case placed on suspense calendar to await above decision, by Memorandum and Order of the Court, Dec. 15, 1980) (this case involves the extent to which national banks may offer commercial data processing services under the National Bank Act).

It may well be justifiable to permit the public offering of directly financial data processing services by depository institutions, but Congress must specify those financial services in which depository institutions may engage through data processing technology and generally. Congress should also define what it means by "financial" and whether this definition moves beyond existing dictionary definitions. Otherwise, Congress invites years of litigation as has occured over the meaning of the "closely related to banking" standard of the Bank Holding Company Act.

The Holding Company Subsidiary As The Appropriate Vehicle For Expanded Depository Institution Activities

Should Congress grant depository institutions the authority to engage in an expanded range of financial activities, including the provision of financial data processing services, they should be permitted to do so only through a holding company subsidiary rigidly separated from the depository institution itself. Critically important public interest considerations, and the legitimate interests of potential competitors of diversified depository institutions, commend the holding company subsidiary as the only proper vehicle for conduct of expanded financial activities by institutions.

There is a surprising consensus emerging on the holding company subsidiary as a viable and appropriate mechanism for expanded financial activity by depository institutions. This approach has been endorsed by the Administration, the Comptroller of the Currency, the Chairmen of the Federal Reserve Board and the FDIC, the Executive

Secretary of the Federal Financial Institutions Examination Council, banking industry trade associations, trade associations of potential competitors of diversified depository institutions and the Antitrust Division of the Department of Justice.

Congress itself has endorsed the holding company subsidiary approach to expanded financial activities. This took place during 1982, when, in the Export Trading Company Act, Congress permitted banking organizations to engage in export trade services but only through a subsidiary of a bank holding company. Since the late 1960's ADAPSO has maintained that whenever regulated entities with government-granted franchises are permitted to engage in unregulated or competitive activities, they should be permitted to do so only through a maximally separated subsidiary.

The separate subsidiary approach to asset deregulation for depository institutions will serve the various interests affected by expanded product and service powers for these institutions. It should permit depository institutions to obtain, on a timely basis, whatever legitimate authority they need to compete with non-depository, financial organizations. It should adequately insulate depositor's funds from the risk and demands of competitive activities. It should preserve and protect the essential role and functions of depository institutions in our nation's economy. Finally, the separate holding company subsidiary approach should adequately identify and minimize the opportunity for competitive subsidiaries to exploit the unfair, marketplace advantages that otherwise would flow from unrestricted affiliation with depository institutions having credit-granting franchises.

The debate that remains is focused on whether the separate subsidiary approach will serve effectively the competing interests and needs identified above. It is our position that the holding company subsidiary tool will work and that its efficacy is directly a function of the extent of separation between the depository institution and its competitive, "financial" subsidiary. We believe that this separation ought to be rigid and structural, established by statute, and accompanied by simple yet full disclosure of all transactions and dealings between the separated entities.

What we have in mind in terms of statutory separation requirements for holding companies with depository and competitive subsidiaries would be based on the following principles:

1. A competitive subsidiary shall be a separate and independent corporate entity with capitalization and financing from unaffiliated sources on the same terms and conditions as would apply to a non-affiliated competitor similarly situated;
2. A competitive subsidiary shall exist as a separate, independent and profit-oriented operation and shall not be subsidized in any manner by an affiliated depository institution, either directly or indirectly through other affiliates of the depository institution;
3. The services performed by a competitive subsidiary shall be explicitly priced and shall not be paid for on the basis of imputed earnings of deposits maintained at, or loan arrangements with, an affiliated depository or other subsidiary of the parent holding company;
4. The conduct of all business between a depository institution and its competitive affiliates shall be on a completely arm's length basis without any preference arising out of affiliation, and shall be performed pursuant to contract publicly filed and at fully compensatory price, and in no event, less than market price;
5. A depository institution shall not discriminate against competitors of its affiliates as to the availability of, or the terms and conditions for, (1) credit or loans, and (2) account information and debit/credit functions necessary to the performance of data processing services;
6. An affiliated competitive subsidiary and depository institution shall not disclose to the other any proprietary customer information unless such information is made publicly available on an identical basis.

These principles for the separate holding company subsidiary engaged in competitive, "financial" activities are derived in large part from decisions of the Federal Reserve Board itself and persuasive testimony presented to the Senate Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs.[3] The structural separation and reporting principles are designed to insulate the depository institution from the high risk and costs associated with affiliate entry into the data processing services marketplace[4], among others, should such entry be permitted by Congress in the first place. These principles should also serve to minimize if not nullify the opportunity for depository institutions to subsidize the activities of their competitive affiliates.

These principles of separation are also structured to deal with the enormous and unfair competitive advantages possessed by affiliates of depository institutions having credit-granting franchises. Chief among these advantages is the ability of banks, and now savings-and-loan associations and savings banks, to control significant commercial loan transactions and to grant credit.

Access to commercial loans and credit generally is of utmost significance, indeed, essential to all businesses, large and small alike. Businesses go to substantial lengths to protect, create and enhance a credit relationship with a banking organization, in part because the credit process is a discretionary one and money is scarce.

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[3] See especially 12 C.F.R. §§ 225.4(a) (12), 225.125, 225.129 (1982); 12 C.F.R. §§ 225.123 (e) (47 Fed. Reg. 37373 (Aug. 26, 1982)) (accounting separation for data processing services); Multibank Financial Corp., Federal Reserve Board Decision (May 15, 1981) and The Conifer Group, Inc., Federal Reserve Board Decision (April 3, 1981) (structural and inter-company dealings separation for data processing services); Written Statement of William M. Isaac, Chairman, Federal Deposit Insurance Corporation, supra note 1, at 7-8; Securities Activities of Depository Institutions, Hearings on S. 1720 Before the Senate Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, 97th Cong. 2nd Sess., at 68, 89, 101-02 (regarding different name requirement) (1982).

[4] According to the ABA-commissioned study, "Assessment of Business Expansion Opportunities for Banking" (Arthur Young & Company, February, 1983), the data processing services business involves medium to high capital requirements, high skill intensity, a significant critical mass in some cases, limited product and service synergism with banking, and substantial risk prompted by this highly obsolesence sensitive marketplace. In addition, data processing entry by banking institutions is not motivated by defensive considerations although it is a highly profitable market. See id. at 24, 31-32.

This effort to secure access to credit and to retain the banking organization's favor takes many forms. Of principal concern is where this credit power induces the existing or potential customer to patronize other affiliates of the depository institution having credit-granting powers, in the hope that the customer will have a chance or a better chance to obtain lifeblood credit on favorable terms.

The credit power, then, results in more business for the affiliate, not on the basis of the quality or price of the affiliate's offering but, rather, as a means to obtain access to the banking institution's scarce commodity, credit. This scenario has been called the voluntary tie-in. Its consequences are the same as those of coercive tie-ins — competitors of the institution's affiliate are foreclosed from part of the market for reasons unrelated to the competitive merits of their products and consumers may be overcharged or may be induced by the credit power to make unnecessary purchases.

Two marketing developments taking place in the bank industry, in particular, threaten proliferation of the voluntary tie-in. "Full relationship pricing" dictates that the more business a customer conducts with his banking institution, the greater the price discount on any one service taken. In addition, banking organization employees are now urged to "cross-sell" the full range of products and services available from the institution when someone opens an account, seeks a loan or otherwise conducts usual bank business. These developments only enhance the possibility that a business or individual will patronize the competitive subsidiaries of a banking organization in order to curry the favor of the credit-granting depository institution.

The six structural separation and reporting principles proposed will serve to identify and minimize the opportunity for commercial exploitation of the credit-granting power by affiliates of depository institutions and by the institutions themselves. These principles will also reduce the continuing anticompetitive practice whereby free or below-cost data processing services are provided to correspondent banks and customers generally in exchange for the deposit or maintenance of non-interest bearing, "compensating" balances with the depository institution.

The separate subsidiary approach that we have proposed is not a fail-safe mechanism but it has worked in other situations. The computer services industry was able to grow from an uncertain infancy when IBM was required by its 1956 consent decree with the Department of Justice to conduct its "service bureau business" in a subsidiary separated from its computer equipment business.[5] Similarly, the software products business realized phenomenal growth after IBM, under the pressure of litigation, began to price explicitly its software in the late 1960's. Congress is well aware of the reliance by the Federal Communications Commission on the separate subsidiary mechanism for the unregulated, competitive activities of AT&T and regulated communications carriers.

We believe that the separate subsidiary requirement for the conduct of expanded financial activities by depository institutions is an appropriate quid pro quo for relaxation of the stringent, public-policy based limitations on the product and service powers of these institutions. Some compelling arguments have been made that small banks as well as small savings-and-loan associations and savings banks, and that credit unions generally, should be exempted from the requirement that expanded financial activities be conducted through a holding company subsidiary. Notwithstanding these arguments, some adequate form of separation is called for, if only to identify and minimize the opportunities for risky and detrimental cross-subsidy.

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[5] United States v. International Business Machines Corporation, [1956] Trade Cas. (CCH) ¶ 68, 245, at 71, 125.

The Role Of The Federal Reserve In The Provision Of Electronic Payment Services

My final point today is in the form of a request. ADAPSO and USERS, INC., ask this Committee to include within its schedule of hearings an investigation of the proprietary and fairness of current Federal Reserve competition with the private sector. The Federal Reserve System, a regulator and a government organization, has embarked on a dramatic campaign to compete with both computer service firms and depository institutions in the marketplace for electronic payment services.

The Federal Reserve System dominates this country's system of automated clearinghouses (ACH's). Of the 37 operational ACH's, 36 are run under the auspices of the Federal Reserve, which provides settlement services and in competition with the private sector, clearing and delivery services. The Federal Reserve continues to receive widespread and sharp criticism that its prices for its ACH, check collection and wire transfer services are subsidized with revenues from its monetary policy operations. As you well know, the Federal Reserve first charged for its electronically payment services only after it was specifically required to do so by the Monetary Control Act of 1980. The criticism continues that the Federal Reserve's prices for its ACH services, among others, are so unfairly low they discourage the private sector from even considering entry into this area. It is also argued that the Federal Reserve's proper role in the ACH area should be one involving solely settlement functions.

This is only one part of the controversy surrounding Federal Reserve competition in the electronic payments marketplace. The Federal Reserve has further entrenched and enhanced its role in electronic payment services through its establishment and management of the Federal Reserve Communications System for the Eighties (FRCS-80).

FRCS-80 is a sophisticated, general purpose data communication network which will interconnect the Federal Reserve Banks, The Treasury Department, ACH processing sites and financial institutions. The technical characteristics of FRCS-80 are such that it is practical if not compelling for the Federal Reserve to expand its role in providing commercial transactions for the private sector. FRCS-80 also enables a significant data processing and transmission role for the Federal Reserve in point-of-sale transactions as well as telephone bill payment and automated teller machine transactions. It has been reported that the Federal Reserve has been marketing small computers to induce financial institutions to participate on an accelerated basis in the ACH and FRCS-80 services provided by the Fed.[6]

Private sector firms, banking trade associations, ADAPSO, NTIA, the Antitrust Division of the Department of Justice, the staff of the FTC's Bureaus of Competition and Economics have each criticized the subsidized, below-cost and unfair pricing of ACH services by the Federal Reserve. These groups have likewise charged that the Fed's enhanced participation in electronic payment services, through FRCS-80, is a substantial deterrent to private sector entry into electronic payment services. Much of this has transpired without ongoing and specific Congressional examination and approval.

These twin developments in the electronic payments field pose significant competitive questions and cast doubt as to whether an otherwise ready and willing private sector will become involved in the delivery of electronic payment services. The Federal Reserve's current role in this area of the financial services industry is highly disturbing. Whether the Federal Reserve System should continue its dominant and accelerating role in the electronic payments service area and, if so, at what price, are questions we ask this Committee to investigate and resolve before events and commitments outrun any remedy.

On behalf of ADAPSO and USERS, INC., thank you for this opportunity to submit testimony on S. 2134 and S. 2181. We look forward to working with you and your fine staff to arrive at legislation that creates a "level playing field" for all participants in the financial services industry, including computer service firms.

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[6] American Banker, "New Links Opening to Fed Services," at p.1, col. 1 (Sept. 29, 1982).

National Retail Merchants Association
NRMA

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1984 MAY 29 PM 4: 22

May 25, 1984

Honorable Jake Garn
Chairman
Committee on Banking, Housing and
Urban Affairs
534 Dirksen Senate Office Building
United States Senate
Washington, D.C. 20510

Re: Retailing's Statement Regarding Banking Deregulation

Dear Mr. Chairman:

The Senate Banking Committee is currently holding hearings on S. 2181, S. 2134 and S. 1609, proposed legislation which would change the way our financial system meets the needs of the American consumer. The enclosed statement of the National Retail Merchants Association addresses one of the most important and controversial aspects of this subject — the extent to which nonbanking businesses should be permitted to be involved in the delivery of financial services. You may be asked to vote on this issue within the next few weeks.

Although in recent months the subject of the involvement of nonbanking businesses in banking has received a great deal of attention, it is sometimes difficult to identify the truly valid concerns. We respectfully ask you to read the enclosed statement carefully before making any decision to restrict the right of retailers to compete in the financial services marketplace. The enactment of legislation to prohibit retailers and other nonbanking enterprises from owning thrifts and limited purpose banks clearly would not be necessary to assure the safety and soundness of the American banking system. To the contrary, it would be anticompetitive, inefficient and ultimately costly for the American consumer.

Sincerely,

Verrick O. French
Senior Vice President
Governmental Affairs

VOF/TM/pmm
Enclosure

EXECUTIVE OFFICERS

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Chairman and Chief Executive Officer
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First Vice Chairman of the Board
SUMNER FELDBERG
Chairman of the Board
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STATEMENT

OF THE

NATIONAL RETAIL MERCHANTS ASSOCATION

FOR THE RECORD

ON

BANKING DEREGULATION

In Connection with Hearings on
S. 2181, S. 2134 and S. 1609

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

May 25, 1984

EXECUTIVE OFFICERS

Chairman of the Board
WILLIAM P. ARNOLD
Chairman and Chief Executive Officer
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New York, New York

First Vice Chairman of the Board
SUMNER FELDBERG
Chairman of the Board
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The National Retail Merchants Association (NRMA) is pleased to submit this statement for the record in connection with this Committee's deliberations on banking deregulation.

NRMA is the nation's largest trade association for the general merchandise retail industry. NRMA's members operate approximately 40,000 stores in the United States, distributing in excess of $175 billion annually in goods and services to the American consumer. NRMA's members range in size from the largest chain and department stores and mass merchandisers to small specialty shops and independents.

Deregulation in the banking and thrift industries is one of the most significant public policy issues facing Congress. The American banking system affects the underlying fabric of the lives of our citizens -- it governs the delivery of a broad range of financial services to consumers and business. In recent years, the banking and thrift industries have become involved in an effort to expand the sphere of their activities to insurance, securities underwriting, and other fields of commerce. At the same time, nonfinancial organizations have been seeking affiliation with banks and thrifts. These activities raise numerous and exceedingly complex issues of public policy. Retailing has a strong interest in the progress of these deliberations.

This statement deals chiefly with the question of whether it is in the public interest to permit nonfinancial business enterprises to be affiliated with financial institutions. We do not attempt to address the broad range of other subjects addressed in S. 2181, The Financial Services Competitive Equity Act, such as the extent to which federally regulated banks should be permitted to branch, the realignment of financial regulatory agencies, or other matters which are largely intra-industry in nature. The other major issues addressed in S. 2181 that concern retailing -- preemption of state finance charge ceilings (Title VII) and credit card fraud (Title IX) -- have been the subject of comment on prior occasions and we will not lengthen this statement by repeating those discussions.

Dynamic Changes in Retailing

The banking industry is not alone in undergoing transformation. Retailing is experiencing tremendous change as well, both as to the way goods and services are marketed, and as to the range of services offered to consumers. The changing nature of the American consumer -- more than 60% of the U.S. population was born after World War II and more than 50% of households have two paychecks -- means that retailers must meet the demands of a new dual-paycheck, leisure-oriented and time-restricted consumer. At the same time, 52%

of the population in the U.S. has an annual income of less than $20,000. This group includes the young, retirees and semi-skilled blue collar workers. These mass market customers are also courted by retailers. To serve this diverse market, specialty shops, mail order sales and off-price merchants have become very influential factors in retailing. Consumers are still interested in value, but convenience has become a major consideration.

Retailers are thus restructuring to meet the demands of a changing populace. Factors such as internal productivity, enhanced by new point-of-sale equipment and modern theories of space management, are receiving heavy emphasis. At the same time, retailers are challenged to offer services that will attract new customers and satisfy existing ones.

Retailers are responding to these challenges in several ways. Some are offering financial services products that originate with other institutions. Other retailers have become affiliated with financial institutions, such as savings and loan associations, state-chartered banks and national banks.

We believe that this activity does not threaten commercial banking. Rather, it stimulates all segments of the marketplace to compete and better serve consumers' financial services needs.

Falling Barriers Between Banking and Commerce

Traditional barriers which, in the past, had separated banking from other industries, have gradually deteriorated. Until very recently, there was a clear demarcation between commercial banking and securities activity. This demarcation has become blurred. Banks, both national and state-chartered, are now performing discount brokerage for their customers. National banks have been authorized to provide a full range of investment advisory activities. Securities firms, too, have broken through and are engaging in many bank-like activities. Money-market funds have become viable competitors with traditional bank deposit accounts. The cash management accounts being offered to customers of some brokerage houses have also become competitive with traditional bank products. Finally, securities firms have acquired or formed "nonbank banks," which are discussed below.

In the insurance area, too, traditional barriers have fallen. Banks may now sell credit-related insurance. National banks have even been permitted to rent space within their branches to insurance companies. Bank holding companies underwrite certain credit-related insurance.

State-chartered banks in some states have been permitted even broader involvement in the insurance area. Insurance companies have become affiliated, in recent years, with banks, savings and loan associations, and securities firms.

The traditional separation between banking and retailing has also been eroded. Although banks are not yet involved in direct retailing activities, holders of certain bank credit cards may now do catalog shopping, courtesy of their banks. Within the next few years, the debit card may change the way the average consumer shops. In this connection, some retailers are now investing their own funds in automated teller machines (ATMs), which financial institutions are then invited to participate in without owning or renting the ATM. Although a district court judge has recently ruled that such an ATM is a branch,[1] thus restricting the bank's customers to using only those ATMs located where the bank could establish a branch, this position is far from settled, and the field of retailer-bank debit card involvement is merely in its infancy.

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[1] Independent Bankers Assn. of New York State, Inc., et al. v. Marine Midland Bank, N.A., et al., civ-83-1006T, W.D. N.Y., decided April 6, 1984.

The Need For A Coherent Congressional Policy

The Financial Services Competitive Equity Act, S. 2181, would permit bank and savings and loan holding companies to engage in a variety of financial services activities. This legislation would permit securities and insurance firms to engage in banking, while bank holding companies could engage in insurance, securities and financial management activities. These proposals envision that bank holding companies would be permitted to offer these new services only through nonbanking subsidiaries and not through affiliated banks.

The debate over whether banks should be permitted to offer nonbanking services centers around the issue of competitive necessity. Banks argue that in an increasingly competitive and national financial services market, it is not fair to deny them the right to compete with a growing number of nondepository institutions. As we will discuss below, however, the banking industry takes a one-sided approach. It opposes the entry of nonbank businesses into the market for financial services.

Those in the insurance, securities and real estate industries, on the other hand, want to ensure that banks cannot use their special attributes, such as their access to funds through insured deposits, to compete with those who do not have such advantages.

Congress should resolve this question. One of the consequences of Congressional inaction is that banks are turning to the states for relief. Indeed, recent changes in the laws of certain states, such as South Dakota, are an indication that a number of states will seriously consider the possibility of attracting banks by offering them an opportunity to offer a broad range of financial services. In this connection, both New Jersey and New York are actively considering expanding the powers of their state banks. This activity is in large measure due to the recognition on the part of many states that granting broad latitude to state-chartered banks can bring new business by attracting out-of-state bank holding companies into the state to form new banks. In addition to increased revenue, this creates new jobs to bolster the state's economy. These states understand full well that if they fail to adopt laws favorable to their banks, these institutions may move to more accommodating jurisdictions, or at least will consider moving certain of their operations to other states.

Thus, deregulation on the state level will take place, irrespective of action by the Congress. Nevertheless, the need to establish coherent, uniform policy on the federal level is very important. In the course of resolving the question of the extent to which banks should be permitted to offer financial services directly, however, Congress should not prohibit nonbanking institutions from owing banking and thrift institutions.

Bank Holding Company Participation in Nonbanking Activities

The Bank Holding Company Act (BHCA) is administered by the Federal Reserve Board (FRB). Section 4 of the BHCA limits the range of nonbanking activities in which bank holding companies (BHCs) and their nonbanking subsidiaries may engage. It is important to note, however, that the BHCA's restrictions on nonbanking activities applies only to BHCs and their nonbanking subsidiaries, but not to their subsidiary banks. Thus, as mentioned above, to the extent that state-chartered banks which are part of a holding company system are permitted by state law to engage directly in certain nonbanking activities (such as insurance brokerage, which has been recommended for New York banks by a New York Commission), such activity would not run afoul of the BHCA.

In 1970 Congress amended the definition of a "bank" in the BHCA to incorporate the requirement that, in addition to accepting demand deposits, the institution also be in the business of making commercial loans. In so doing, Congress intentionally created a class of depository institution that would not be considered a bank for purposes of the BHCA and that could be acquired by all types of nonbanking organizations. Savings banks, trust companies and industrial banks were not intended to be covered as "banks" because these entities did not function like traditional commercial banks. Beginning around 1980, the "nonbank bank" phenomenon developed as a natural consequence of the legitimate desire of certain institutions to meet consumers' demands for a more competitive and efficient marketplace for financial services.

Thus, until now, nonbanking institutions have been forced to avoid the BHCA's restrictions (in Section 2(c)) by creating or acquiring financial subsidiaries that offer certain banking services but do not meet the BHCA definition of "bank." These subsidiaries either do not take demand deposits or, more often, are not engaged in the business of making commercial loans (the latter are sometimes referred to in this statement as "consumer banks"). Efforts to enter the financial services marketplace in this manner have been met with considerable resistance from the FRB and stiff opposition by some segments of the banking industry.

The key question for Congress is whether there is an overriding public policy that requires total separation between banks and other commercial enterprises. We believe that there is no sound economic or public policy basis for such a rigid requirement.

The BHCA was enacted to prevent the undue concentration of banking resources, to separate banking activities from commerce, and to ensure that the performance of nonbanking activities by BHCs is prudent with regard to risk, safety and soundness, conflicts of interest, and the maintenance of impartiality in the granting of credit.

With the exception of the notion that banking and commerce should be separate, all of these principles can be preserved in a competitive and efficient marketplace for financial services. As we outlined briefly above, however, much has happened in recent years to cause Congress to reconsider the doctrine of the separation of banking and commerce.

NRMA strongly supports the principle that competition in the consumer financial services marketplace benefits consumers by bringing about innovation, a lowering of the costs of financial services, improved marketplace efficiencies, greater diversity of products and services, and an acceleration of technology. These are the results when bank holding companies are permitted to participate in nonbanking activities. At the same time, competition prevents concentrations of power and higher prices that are typical of noncompetitive markets. As we will discuss in more detail below, there is no evidence that the safety or soundness of financial institutions is adversely affected when retailers and other types of businesses are allowed to participate in banking by means of ownership of banks. To the contrary, this relatively recent phenomenon stimulates the marketplace and improves the overall system of delivering financial services to consumers.

The uncertainty surrounding the legality of creating or acquiring a nonbank bank should be resolved by Congress. This action, however, should not take the form of a moratorium upon such activity. Last year, the Comptroller of the Currency announced, and subsequently extended, a limited moratorium on its approval of applications to establish nonbank banks. The moratorium expired on March 31, 1984 but it was reimposed on May 9, 1984, retroactive to April 1, 1984, to expire at the end of the current Congressional session.

We strongly oppose the Comptroller's moratorium, legislation such as H.R. 3413, which would impose a moratorium upon the acquisition of nonbank banks until December 31, 1984, and H.R. 3499 and H.R. 5343, which also would impose temporary or permanent moratoriums. The moratorium in H.R. 3413 would apply to the acquisition of FDIC-insured banks or banks eligible for such insurance. In addition, H.R. 3413 would force divestiture of any nonbank bank acquired after June 23, 1983 by any company that, because of its nonbanking activities, could not own a bank under the BHCA.

The Comptroller's moratorium is the direct result of a flurry of activity by banks seeking to establish nonbank banks, rather than the result of activity by nonbanking entities. Irrespective of what has precipitated it, stop-gap measures such as a moratorium on acquisitions of nonbank banks are, we believe, not the solution to the issues confronting Congress. Such action merely delays decisionmaking. The longer the current uncertainty exists, the greater the risk incurred by those who have acted. For example, the FRB is seeking divestiture of banks acquired or established by nonbanking institutions. We agree with the recent subcommittee report approved by the House Government Operations Committee that what is needed is a progressive, meaningful federal blueprint for the nation's financial structure, rather than a temporary federal embargo on current activity.

Although we will not undertake a review of the extensive regulatory developments in this area, it is important to point out that, in addition to the Comptroller's moratorium, the FRB recently revised Regulation Y, the regulation which implements the BHCA, to broaden the definitions of "demand deposits" and "commercial loans" under the BHCA. This redefinition, which seems to have little or no support in the legislative history of the BHCA, has been challenged in the courts. The FRB has provided a procedure to obtain limited "grandfather" rights for companies that acquired nonbank banks in reliance upon the more narrow definition of "commercial loans" prior to the Board's broadening of that definition, accomplished in the Board's December 10, 1982 letter to the Dreyfus Corporation. In spite of this, the Board's action in amending Regulation Y is intended to severely hamper further acquisition of nonbank banks by commercial enterprises.

Congress should make it clear that the affiliation of a bank with a nonbanking institution is not inherently inappropriate. As long as the safety and soundness of the bank is otherwise assured, there is nothing improper about a nonbank owning a bank. Moreover, legislative proposals should not limit such affiliations to those between banks and nonbanking companies in the financial services industry, as distinguished from nonbanking companies in retailing or other fields of general commerce.

The Consumer Bank Concept

S. 2181 would establish the definition of "consumer bank," and exclude such banks from the definition of "bank" under the BHCA. These banks would not be permitted to engage in the business of making commercial loans.

We support the concept of consumer banks. We are concerned, however, that the definition of "commercial loans" may be too all-encompassing. In one important respect, this definition does not follow the broad approach taken by the FRB in Regulation Y. That is, it excludes money market transactions, such as buying CDs, and selling Fed funds. The definition also includes a five-percent-of-assets exclusion for small business loans, the financing of consumer goods inventories or similar purposes. We recommend that this definition also expressly exclude the purchase of consumer transactions originated by retailers, where the transaction otherwise meets the bank's normal credit standards. This is a standard similar to that adopted by the FRB in determining whether the purchase by a bank of an affiliate's loan should be considered a loan to the affiliate. The purchase of a retailer's transactions is in essence an extension of credit to the consumer, rather than to the commercial entity, and would not involve the kinds of hazards that are perceived to arise when loans are made to commercial enterprises under circumstances where the commercial enterprises are the direct obligors.

S. 2181 also would limit the establishment or acquisition of consumer banks by a company outside the state in which the operations of the company's consumer bank subsidiaries were principally conducted on July 1, 1983, unless such acquisition is specifically authorized by the laws of the state in which the consumer bank to be acquired is located, or unless state law specifically authorizes interstate banking. Such a geographic restriction is archaic and has no meaning in today's economy. The incidence of interstate banking, particularly by major banks, is by now well known. Since the legal barriers to interstate banking (the 1927 McFadden Act and the BHCA) have proven to be no obstacle to creative banks, they should not be erected for nonbanking institutions.

S. 2134, introduced by Senator Proxmire, would, among other things, redefine "bank" under the BHCA to include all FDIC-insured banks. This bill, and S. 1609, would prevent diversified nonbanking institutions from gaining access to the deposit market and the payment system aspects of consumer financial services. NRMA opposes the restrictive approaches of S. 2134 and S. 1609.

NRMA believes that the Congress should not delegate to the Board, or to any other regulatory body, broad authority to decide the proper delineation between banking and commerce in this country. Rather, explicit standards should be set for all federal agencies charged with regulating financial institutions, and those agencies should be required to develop integrated and coordinated policies for interpreting the laws they administer.

At a bare minimum, Congress should not permit existing policy, established by the 1970 amendments to the BHCA, to be undermined by the Federal Reserve Board or by those in the commercial banking industry who would frustrate progress to preserve their present market share.

NRMA recognizes that banks play a unique and critical role in the nation's financial system and economy. Congress has provided these institutions with federal deposit insurance, among other important attributes. Banks should continue to be subject to prudential limitations designed to limit risk, promote sound operations, assure impartiality in the credit granting process, and prevent excessive concentration of credit resources. We believe, however, that these concerns can be met and, in numerous instances, currently are being met, without requiring a rigid application of the doctrine that commerce and banking must be separate.

There is nothing intrinsically offensive in a financial institution that is owned by a corporation engaged in commerce accepting deposits and enjoying the benefits of bank status. Consumer banks are and, under the proposed legislation, would continue to be extensively regulated. Limitations such as those concerning sound operations, limits on risk, and impartial credit granting can and will be maintained in the case of consumer banks, as they are in the case of banks subject to the BHCA.

Whether the consumer bank has a charter issued under federal or state banking laws, it would be subject to essentially the same type of regulatory framework that is applied to banks that are subject to the BHCA. State-chartered banks are subject to the FDIC Act, the Consumer Credit Protection Act and several other laws. In addition to these, national banks are subject to the National Bank Act, the Federal Reserve Act and other laws.

We believe that the nonbanking activities of the affiliates of consumer banks, which do not make commercial loans, do not raise the kind of policy concerns that the BHCA was designed to address. As long as banks that are outside the scope of the BHCA are not permitted to operate so as to favor, or engage in acts whereby another bank would favor, the nonbanking affiliate, there is no need to prevent nonbanking companies from owning banks. Similarly, as long as the consumer bank is not permitted to make loans to customers of the nonbanking affiliate on terms more favorable than the terms offered to consumers at large, there are no inherent abuses that could result from such ownership. Further, the concern about safety and soundness, concentration of resources, and/or conflicts of interest that could arise due to the common ownership of banks and commercial organizations can and should be addressed without prohibiting such common ownership on a *per se* basis.

With regard to the safety and soundness of the banking system, consumer banks are not a threat. Consumer banks by their nature engage in relatively low risk, highly liquid and widely diversified lending activities. Unlike commercial bank portfolios, which are subject to greater fluctuations in market value, consumer banks often make loans which have shorter maturities and, because of recent adjustments in the mortgage lending industry, loans that generally are not subject to sharp fluctuations in market value. Because of the diversity of the portfolios of consumer banks, there is no comparison between the relatively low risk involved in consumer banking and the risks involved in commercial loans, some of which are highly speculative and, in the case of some loans to foreign countries and certain large corporations, have proven to be extremely imprudent.

With respect to the concern about concentration of resources, we believe that today's dynamic and highly competitive marketplace should assure that a few nonbanking organizations will not be able to dominate the financial services market. There have been no indications to date of a trend toward undue concentration occasioned by the nonbank bank exception to the BHCA. To the contrary, it appears that this phenomenon has fostered rather than stifled competition. The wide variety of businesses that have acquired nonbank banks to date have stimulated these and other institutions to offer new and creative financial products at competitive prices. This enhances rather than harms the financial services marketplace and the welfare of consumers.

Although vigorous competition will resolve the question of undue concentration, the law should make it clear that no financial institution shall be permitted to favor certain borrowers over others. The way to assure impartiality in lending is to develop clear statutory guidelines and real deterrence to engaging in prohibited conduct, rather than requiring an absolute separation between banking and other commercial enterprises.

Congress made it illegal to discriminate on the basis of race, religion, sex and marital status, among other protected categories, when it enacted and amended the Equal Credit Opportunity Act. It can accomplish the same goal of impartiality by expressly making it unlawful for a bank to make its credit available to the customers of the affiliated business on terms more favorable than those available to customers of other businesses not so affiliated or consumers at large. Indeed, this restriction should also apply to commercial banks which own securities or insurance firms.

There is no basis on which to justify the FRB's assumption that a business will acquire a bank and make credit more readily available to that business' customers, as opposed to consumers at large. Although it is true that retailers and other businesses may acquire a bank and that bank may choose to lend to the customers of the affiliated business, there is no reason to fear that the bank will favor the customers of its affiliated business. There is no real threat that acquired consumer banks will operate in a manner so as to further the interests of the company that owns that bank by sacrificing the interests of consumers or jeopardizing the safety and soundness of the bank.

The FRB advocates a blanket prohibition against a nonbanking institution acquiring a bank of any kind because the FRB fears that the acquired bank would require prospective borrowers to buy insurance, securities or other goods and services from affiliates in order to receive an extension of credit from the bank. The FRB asserts that such coercive practices will be rampant and will give the affiliates a serious competitive advantage over other businesses. At the same time, the FRB theorizes, this will seriously undermine the structure of the banking system as we know it.

The answer is not to require separation of business and consumer banks. Just as Congress prevented coercive practices in connection with creditors' sale of credit insurance to consumers, by incorporating appropriate provisions and strict liability for violations in the Truth-in-Lending Act, Congress can take similar action to prevent coercive practices by consumer banks. Also, the anti-tying provisions of the BHCA could be extended to cover this potential abuse. In any case, the anti-tying provisions of the Sherman Act will effectively prevent the practices which are of concern to the FRB in this regard.

Another argument against nonbank banks is that such acquisitions would allow for the expansion of banking across state lines without either state authorization or Congressional approval. In fact, the present ban on interstate acquisitions represents an archaic doctrine that should be reevaluated. Indeed, the ban is largely illusory, in view of the numerous exceptions to the purported prohibitions against interstate banking. Although the issue of the permissible range of interstate banking is outside the scope of this statement, we note in passing that there is a broad base of sentiment in favor of substantial liberalization of present statutory limitations on interstate branching by national banks and the acquisition of banks across state lines by bank holding companies.[2]

There are several examples of institutions that engage in deposit taking and lending that are owned by nonbank organizations. For instance, industrial banks have for years operated under the laws of more than twenty states. These banks are primarily consumer lenders, although they also make loans to small businesses. Until the FRB amended Regulation Y recently, these institutions have not been classified as "banks" under the BHCA.

The long-standing relationship between commerce and thrifts also illustrates our contention that such a relationship is not inherently inappropriate. Unlike BHCs, which are prohibited by the BHCA from acquiring any nonbanking organization, unitary savings and loan holding companies are permitted to own savings and loan associations and savings banks while conducting a nonbanking business. There are no restrictions on a unitary S&L holding company (one that controls a single subsidiary FSLIC-insured institution) insofar as the type of business in which it or its subsidiaries may engage. It is subject only to the restriction that it and its subsidiaries may not engage in activities that would have the effect of evading a law or regulation applicable to the savings and loan subsidiary. No regulatory authority need approve or be notified prior to the commencement of any activity of a unitary S&L holding company. Moreover, the service corporations of federally chartered savings and loan associations are free to engage in a wide range of activity (real estate brokerage, land development, management consulting, certain insurance activities, property management, among others) that are prohibited for BHCs and their affiliates.

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[2] See Geographic Restrictions on Commercial Banking in the United States: The Report of the President, report prepared by a multi-agency task force and issued in January, 1981.

It is difficult to reconcile the divergent approaches to permissible ownership of a consumer bank by a nonbank, versus permissible ownership of a savings and loan association. Although a savings and loan is now permitted to engage in the activity of both accepting demand deposits and, to a limited extent, making commercial loans, the institution is for many purposes on the same footing with a consumer bank -- a "nonbank bank" that accepts demand deposits but is not in the business of making commercial loans. During the last fifty years there has been no evidence of harm to the public or to the thrift industry by virtue of the ownership of thrifts by nonbanking organizations. Why then should there be concern about the ownership by nonbanking organizations, of an institution, such as a consumer bank, which is largely on the same footing with a thrift?

The Qualified Thrift Lender Concept

The primary focus of this statement has been devoted to the principle that nonbanking institutions should not be prevented from affiliating with limited purpose banks. In doing so, however, we in no way mean to imply that a similar legislative proposal for thrift institutions -- the "qualified thrift lender" -- is of lesser importance.

We have devoted the majority of this discussion to the consumer bank concept because, as mentioned above, nonfinancial entities have long had the opportunity to offer financial services as a unitary savings and loan association holding company. We want to make it clear that we strongly oppose any proposed legislation which would amend current law to deny savings and loan associations the right to be owned by a holding company that is in the field of general commerce. Rather, we support the approach of S. 2181 which, in addition to authorizing a consumer bank, provides for a "qualified thrift lender," a special purpose thrift that could be owned or controlled by a holding company engaged in offering nonfinancial services.

The option to engage in financial services activities by establishing or acquiring a limited purpose bank, or a qualified thrift lender, should be available to a commercial enterprise according to the dictates of the competitive marketplace. Both types of financial services entities are based upon the same principle -- that if the activities of an insured depository institution are sufficiently limited, there is no reason to subject its holding company to restrictions regarding that holding company's non-banking business.

Conclusion

NRMA urges Congress to approve the concepts of consumer banks and qualified thrift lenders, which may be affiliated with and owned by nonfinancial businesses. We recognize that the FRB is committed to preserving the safety and soundness of the federal banking industry and enhancing the competitive functioning of that industry. We applaud and support that commitment. It is our position, however, that there is nothing inconsistent between the promotion of these goals and properly delineated affiliations between nonbanking organizations and banks or thrifts. Moreover, the FRB should not by regulatory fiat narrow a category of financial institution created by Congress. When it does this, the FRB acts not as the legal interpreter of laws enacted by Congress but as a policymaker. To the contrary, it is the role of Congress to resolve the essential policy questions that have arisen as a result of the nonbank bank controversy.

The current statutory provisions that separate commerce from banking are based upon artificial distinctions that are largely the result of historical accidents. They should not be perpetuated. The BHCA definition of bank should be narrowly contrued to maximize the opportunity for inter-industry affiliations. Clearly, there is room in our multifaceted banking structure for a bank, owned by a commercial concern, which serves as a consumer bank. The resulting competition will serve the public interest far more than will continued preservation of restricted markets for the protection of the interests of commercial banking.

NRMA appreciates the opportunity to present the views of retailing on this important issue.

COMPETITIVE EQUITY IN THE FINANCIAL SERVICES INDUSTRY

PART III

TUESDAY, MARCH 13, 1984

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn and Gorton.

OPENING REMARKS OF SENATOR GORTON

Senator Gorton. This is a continuation of hearings on S. 2181, the Financial Services Competitive Equity Act, and S. 2134, the Depository Institutions Holding Company Act Amendments.

Senator Garn asked me to announce that he will not be here for an hour or more due to a meeting with the majority leader, Senator Baker, on the budget.

Today we have two panels of distinguished witnesses representing the financial and business consulting firms, the academic community, and a consumer organization. I expect today's testimony and questioning to be particularly interesting because at least some of the witnesses will approach the issues unburdened by any immediate financial stake in the outcome of the debate. Perhaps in some respects their testimony will be somewhat more daring.

Seeing no other Senator here with an opening statement, the first panel will consist of Mr. Carter Golembe of Golembe Associates, Washington, D.C.; Mr. Harry Keefe—I'm notified that Mr. Keefe never managed to get out of the airport in New York, and Mr. Donald Kaplan, managing associate, Kaplan, Smith and Associates, Washington, D.C.

Mr. Golembe, you may proceed.

STATEMENT OF CARTER GOLEMBE, CHAIRMAN, GOLEMBE ASSOCIATES, INC., WASHINGTON, D.C.

Mr. **Golembe**. Thank you very much, Senator.

Mr. Chairman and members of the Committee: I am Carter H. Golembe, Chairman of Golembe Associates Inc., a financial research and consulting firm located in Washington, D.C. I appreciate the invitation by the Committee to present my views on S. 2181 and S. 2134. These views, I should emphasize, are mine and are not necessarily shared by my colleagues or by the institutions that are numbered among our clients.

For more than 30 years I have advocated significant deregulation of the financial system and a return to more competitive financial markets. In a study prepared in 1981 at the request of the Department of the Treasury, I suggested that the goal of deregulation -- admittedly highly idealistic -- should be a system in which any financial institution is able to offer any financial product or service, at such price and at such locations as are dictated by good business judgment, subject only to limitations imposed by overriding public policy considerations. (Policy Recommendations for the Comprehensive Deregulation of Major Financial Institutions and Markets, Department of the Treasury, September, 1981.)

In my opinion the legislation now being considered by this Committee would take important steps in that direction. My preference is for S. 2181 because it proposes more deregulation than S. 2134, and I would strongly urge the adoption of at least the main deregulation provisions.

As has been described by other witnesses, as well as by the Chairman and other members of this Committee, financial deregulation is progressing at a rapid pace. But it is proceeding in an often unpredictable or seemingly haphazard manner. It is being driven by far-reaching technological change and by fundamental market forces. Deregulation may proceed more or less rapidly, and more or less equitably, depending on action taken by the Congress. But it will proceed.

All financial industries are constrained to a greater or lesser extent by statutory or regulatory constraints on the services they may offer. Most such constraints, but clearly not all, relate to commercial banking, and many of them cut two ways -- preventing banks from expanding into some other businesses and preventing some businesses from entering banking. They had their origin in depression-generated legislation of a half century ago, which sought to solve the problems of that day by restraining competition. Constraints on competition are never acceptable to free market forces, nor does government find such restraints to be desirable now. The legislation now being considered by this Committee deals in substantial part with banking deregulation, but this is not, in the first instance at least, because of some urgent, overriding need to protect banks. Rather, it is because in the unraveling of the complex system of compartmentalized financial institutions, the largest remaining body of restraints relates to commercial banking.

There was a time, not very long ago as a matter of fact, that commercial banks occupied a special position in the financial system, so special indeed that in 1963 the Supreme Court could conclude that commercial banking constituted a distinct line of commerce because banks were able to offer certain services not available for offering by other institutions and, thereby, enjoyed a settled consumer preference for the cluster of services built around this core. (United States v. Philadelphia National Bank, 374 U.S. 321 (1963)). That special position or uniqueness has of course largely disintegrated, particularly because other financial institutions are now able to offer transaction accounts. It is understandable, therefore, that in a rapidly deregulating world, commercial banking is quite concerned about its future viability so long as it is still subject to types of restrictions that do not apply to new competitors offering banking-type services.

To be sure, it is not written in the heavens that when a fully competitive financial system eventually evolves out of the present system, it must contain something called commercial banks. But if there are to be commercial banks, one should not be surprised that those who manage that industry would want to compete on a reasonably equal basis with others who also offer banking and financial services.

Nonetheless, I do not believe that the fundamental case for broadening the range of services banks can offer, referred to as product deregulation, which the proposed legislation would provide, rests on the interests of commercial banks. Rather, the basic case for product deregulation rests on the public stake in more competitive financial markets. Whether in banking, or in the financial industry generally, or in any other industry, there is simply no getting around the fact that the public is benefited by any legislation that will enhance competitive behavior. This is, of course, a fundamental precept in economic theory and, not surprisingly, provides the fundamental basis for the recommendation of product deregulation in the 1984 Economic Report of the President (see particularly p. 150).

It should hardly be necessary, and in any event I will not attempt it, to build a "case" for enhanced competition in financial markets. Nor, so far as I am aware, are those who oppose deregulation for banks arguing the benefits of less competition. Rather, opponents rely on claims that deregulation will result in undue concentration of banking power; that banking organizations will assume more risk than is desirable; or that competition in various of the affected markets is already sufficient, so that bank entry will merely introduce "unfair" competition, such "unfairness" being attributable to deposit insurance or to various other aspects of government's involvement with banking.

The economic case that increased competition is a benefit to the public is so overwhelming that those who oppose pro-competitive legislation clearly bear a heavy burden of proof. The question before this Committee, I should think, is whether their claims have been persuasive; whether the case by the opponents of deregulation has been made. In my opinion it has not.

The arguments advanced by those opponents are not new; they have been offered, with little significant change, for a least several decades. The record of this hearing, as well as that of many previous hearings, is burdened with various claims and counter-claims. I will not, therefore, tax the patience of the Committee by introducing additional detailed material which would be repetitious, but will simply offer a few general observations.

The concern over "banking power" is puzzling because it has several dimensions, at least one of which is not susceptible to analysis. I refer to a vague, generalized fear that in some unexplained manner an admittedly large industry, unless tightly constrained, will act as a single entity, purposefully and under central direction, to dominate the American economy and work it ill. The explanation for some people's having such fears, if an explanation exists at all, must come from such disciplines as sociology or psychology. Economics and law, on the other hand, deal with structural and market realities.

The reality is that banking is a highly competitive industry, comprised of some 12,000 banking organizations (holding companies and non-holding company banks), and so highly fragmented that even the ten largest such organizations accounted for less than 18 percent of the country's bank deposits at the end of 1982. Moreover, authoritative studies consistently show that the trend of deposit concentration among banks has been downward over recent decades, both on a national and on a local (SMSA) level. Indeed, industry concentration data show that banking is far less concentrated than the principal industries (insurance and securities) which, generally, oppose banking deregulation.

But even global figures of this kind miss an essential point, just as adding up the total assets of banks to suggest some frightening capacity for mischief is irrelevant. What is most relevant to the public is the true competitive situation among banks or among all financial insitutions in the markets in which they do business. In this connection the significant question is whether or not there exist such anti-competitive practices as price-fixing or market sharing, leading to monopoly profits. Competition is the public's basic protection against such practices. The studies of which I am aware suggest generally that whatever the nature and size of the markets in which banks participate, that competition is intense and that banks are rarely the only insitutions, and often not even the principal institutions, among financial institutions serving the particular market. And it should always be kept in mind that even where abuses might develop, remedies such as government regulation or application of the antitrust laws directed at a specific problem or set of problems, are available.

Turning to the next point, concern over the risk to banking from a broadening of its services was dealt with, rather persuasively I thought, in the Economic Report of the President (pp. 160-61), where it was pointed out that to the extent that problems exist, the proposed legislation, with its affiliate system, offers proper safeguards. Personally, I doubt that many, if any, of the new activities proposed in the legislation before you are any riskier than is the banking business itself, but risk analysis is a particularly complex matter on which I pretend no expertise.

The President's Economic Report (pp. 161-62) dealt even more extensively and, again, rebutted quite persuasively, the contention that competition by banking organizations would be "unfair." There are several elements to this "unfairness" argument, as you aware, but as the Report points out, all, in essence, fall afoul of the fact that market realities, particularly with the other safeguards built into the legislation, make such allegations unrealistic. Probably I should not have to add that, in general, allegations of "unfair" competition must always be regarded with considerable skepticism; competitors rarely view the prospect of enhanced competition and lower profits in any other light.

Finally, there is the question of whether competition is already sufficient in the several financial markets that would be affected by S. 2181. Of course one could conceive of situations in which markets are so competitive that new entrants would exert no effect on prices or quality of service. However, the intensity of the opposition to bank entry suggests that there may be something more to such opposition.

For example, in the case of underwriting revenue bonds, we find individuals (commercial bankers), presumably possessing a reasonable degree of business acumen, who see profit opportunities in an activity they wish to enter; other individuals (investment bankers), equally knowledgeable about their business, who are vigorously contesting such entry; and users of such services (primarily state and local government financial officials) who for the most part have been quite vocal in suggesting that added competition would be beneficial to them. Thus unless one is prepared to believe that commercial bankers, investment bankers, and the issuers of securities simply do not understand their own businesses or professions, there is no reason to spend a lot of time examining elaborate economic and statistical studies offered by one or another party to support their particular points of view. It is rather obvious that commercial bankers sense profit opportunities; that investment bankers anticipate diminished profits; and that municipal finance officers expect increased savings. This adds up to compelling evidence that the present market is not optimally competitive. The same story, with somewhat different casts of players, can be found with respect to the other industries facing added bank competition from S. 2181.

It can be taken as a given that enactment of the main deregulatory provisions of S. 2181 will create problems for many institutions, including commercial banks. A more competitive world is not nearly as comfortable as one that is hedged about by regulation. It will also create more opportunities for financial institutions, including commercial banks, depending on their ability to react quickly and intelligently to the new competitive world. But the end result is that the public receives its financial services at better prices, and can get them with more convenience, than it could before. This, I submit, is the real reason why the legislation we are discussing should be enacted.

One might agree that in the long run a more competitive financial system would be desirable but still question how urgent it is that Congress act now. It is possible to arrive at different answers depending on how that question is defined. For example, if it were put in such terms as "How urgent is it that Congress act to protect commercial banking organizations?", one might say there is still some time available; it is the future viability of the industry that is of particular concern. Suppose, however, that the question were "How urgent is it that the public be given the full benefits of enhanced competition in the financial system?", or "In a rapidly changing financial world, at what point should Congress step in to assure itself that a sound, fully competitive system is attained over the long run?" The question posed in this way might well justify the answer that congressional action is quite urgent.

I think action by the Congress is desirable now rather than later, not necessarily because some institutions may be advantaged or disadvantaged as a result of waiting but, rather, because the public deserves the benefits of increased competition at an early date. In addition, the rapid pace of deregulation means that if the Congress wants to manage this process and assure itself that, over the long run, important public policy objectives are achieved, delay now would not be desirable.

It is suggested occasionally that deregulation can be halted, or that it is even possible to return to the compartmentalized world of the past by prohibiting entry of non-bank firms into banking, or by requiring specialization of financial institutions. Theoretically perhaps this could be done, but I have serious doubts that it is really possible. Congress, as I said earlier, can substantially influence the pace and direction of financial deregulation. And the present rapidity of deregulation can be attributed in part to earlier congressional initiatives, such as interest deregulation. But there are driving forces for change operating independently of the Congress. The most important of these is the computer/communications revolution affecting all financial institutions. Others include entrepreneurial initiatives and the public's demand for sophisticated and convenient financial services at fair prices. Together, these and other forces assure the continuation of deregulation and make impractical, in my view at least, efforts to turn back the clock.

Let me turn now, briefly, to a consideration of just a few of the provisions in the proposed legislation, with particular reference to S. 2181. In my view, the single most important step that must be taken -- in fact the essential step -- is to remove the constraints now placed on the ability of commercial banking organizations to offer a variety of financial services, as well as to assure that such entry can be accomplished without burdensome and time-consuming procedural requirements. S. 2181 largely accomplishes this main objective by providing that bank holding companies will in the future be permitted to engage in activities determined by the Federal Reserve Board "to be of a financial nature." Significant in this regard is the directive to the Board to promote competition between bank holding companies and other providers of similar financial services. Entry procedures would be streamlined by amending present requirements related to applications and hearings.

Closely related to these provisions is the inclusion in S. 2181 of specific activities designated as financial in nature, such as insurance, certain real estate operations, and entry into the savings and loan business. Also of importance is the proposed authority for bank holding companies to offer, through securities affiliates, certain services now precluded by the Glass-Steagall Act, most notably the underwriting of state and local revenue bonds and of mortgage-backed securities, along with the organizing and management of open-end mutual funds.

I endorse the securities affiliate concept, as well as, in general, the institutional thrust of S. 2181, which is to use the holding company format to accomplish product deregulation. Indeed I urged such an approach in a paper on product deregulation published in 1982 by the Association of Bank Holding Companies. (Product Expansion by Bank Holding Companies, January 1982, Association of Bank Holding Companies)

The product deregulation menu provided by S. 2134 is more limited than S. 2181. Also, the former does not contain the broad authorization for bank holding companies to engage in activities of a financial nature. However, it does provide that the so-called "proper incident" test in the present section 4(c)(8) of the Bank Holding Company Act, relating to activities in which bank holding companies may engage, be dropped and, like S. 2181, it directs the Federal Reserve Board to give primary consideration to the public benefits to be obtained from increased competition. If I understand this correctly, such a change might accomplish the same objective as the use of the words "activities of a financial nature," although the more explicit provision in S. 2181 seems preferable. In any event, elimination of the proper incident test is a most important feature of S. 2134.

Both bills define what a bank is, for purposes of holding company regulation, and S. 2181 also introduces the concepts of a "qualified thrift lender" and a "consumer bank." To the extent that the purpose, and effect, of such definitions is to establish jurisdictional lines among the various agencies for regulatory purposes I see no great problem. In the long run, and possibly in the not so long run, substantial reorganization of the federal regulatory structure will be needed, but it is certainly premature to consider such reorganization until product deregulation is accomplished. But if these definitions are to be used to discriminate among groups of financial institutions with regard to the scope of product deregulation, then it seems to me that they will be mischievous in nature and in effect perpetuate the present unsatisfactory situation.

The matter of the so-called "consumer bank" and "qualified thrift lender" prompts a few additional observations. In general, the idea of defining and compartmentalizing financial institutions goes against the grain of deregulation. In a fully deregulated financial system, authority to establish a consumer bank or to be a qualified thrift lender would be a non-event, but the financial system is not yet fully deregulated, nor will it be if S. 2181 is adopted. Significant product deregulation remains to be accomplished, particularly in the securities area, to say nothing of geographic deregulation. Thus I have serious reservations about creating these new types of depository institutions, since it obviously poses questions of competitive equity. But my reservations diminish to the extent that such definitions are simply part of a program of legislation that accomplishes broad and effective deregulation for commercial banking organizations including, I might add, geographic deregulation.

The only other section of S. 2181 on which I might comment is Title X, which, I understand, is intended to remove constitutional impediments to state efforts to enter into compacts or otherwise agree to the formation of interstate banking regions. In effect, Title X would introduce a new concept, of regional states rights, and thereby accomplish a significant transfer of federal authority to the states. In my view -- which I have argued publicly for several years, beginning with a report published in June 1980 -- such a transfer is not only likely to have unfortunate economic consequences but also raises serious issues about the proper locus of the money power within government. (The Role of the Federal Government in the Shaping of the American Banking Structure, National Conference on Competition in Banking, June 1, 1980. Also: Golembe Reports: "The Predictability of Government," Vol. 1980-5 and "Interstate Banking: Who's in Charge?," Vol. 1981-7; and Banking Expansion Reporter, "Massachusetts and Interstate Banking," January 17, 1983).

In view of the time available, I have not commented on many of the matters dealt with in the comprehensive program set forth in S. 2181. I would, however, be happy to respond to questions on those about which I might have some knowledge or opinion.

Before closing I would like to add that, if it had been possible, I would have preferred to see deposit insurance reform accomplished prior to, or coincident with, product deregulation legislation. The present level of insurance coverage for depository institutions -- de facto now virtually 100 percent -- poses difficult and complex questions of risk assumption and competitive equity. A reform now receiving much attention -- the introduction of risk-related insurance assessments -- will, I fear, be impractical. Yet ways should be found to assure that the market plays a greater role as a regulator of depository institutions, and I hope it will be possible, as one of the next orders of business, to consider some of the other insurance reforms recommended by the FDIC.

The present business before the Committee, however, is product deregulation. Let me reiterate the viewpoint stated at the outset that, taken as a whole, the proposals before this Committee, and the deregulation provisions of S. 2181 in particular, represent an important step toward more competitive financial markets and should be enacted.

Senator GORTON. Thank you, Mr. Golembe.
Mr. Kaplan.

STATEMENT OF DONALD M. KAPLAN, MANAGING ASSOCIATE, KAPLAN, SMITH AND ASSOCIATES, WASHINGTON, D.C.

Mr. Chairman and Members of the Committee, my name is Donald M. Kaplan. I am a co-founder and managing associate of Kaplan, Smith & Associates, Inc., a financial consulting firm specializing in thrift institutions and based in Washington, D.C., Los Angeles, and Atlanta. I want to make it clear that my comments today reflect the views of the senior partners of our firm. My comments do not reflect the views of the firm's clients, except possibly by coincidence.

As one who has witnessed the rapid pace of market-induced deregulation, major Congressional financial reform initiatives in 1980 and in 1982, and many initiatives now coming from the state level, I believe that this distinguished Committee has not one but a large number of tigers by their tails. Events are moving fast on many fronts. A key question before us is whether the pace of financial deregulation should be dictated by market developments and sporadic regulatory agency responses, or whether the pace and direction should be set by an omnibus Federal law that attempts to provide for a more consistent and less ad hoc type of financial deregulation. You have two bills before you. One is S.2181, introduced by Senator Garn, referred to subsequently in this testimony as the Garn bill. The other is S.2134, introduced by Senator Proxmire and referred to subsequently as the Proxmire bill.

The Garn bill takes a more sweeping deregulatory approach. It consists not only of a slightly amended version of S.1609, which had been submitted at the request of the Treasury Department, but also nine sets of proposals introduced by various Senators last year, as noted in the Senate Banking staff analysis. As a result, the Garn bill can properly be viewed as a laundry list of proposals that deal with various facets of financial reform. In contrast, the Proxmire bill is focused centrally on the issue of holding company powers and does not deal with the many other issues raised by the Garn bill.

While I plan to cover the major proposals of the Garn and Proxmire bills, I believe that it would be more fruitful for me to first view them in a broad context. My major stress will be on the public interest--what is in the interest of those who use financial services, which includes just about everyone. In my opinion, the public interest requires reasonable parity in the financial services industry--whether they be depository institutions regulated by bank and thrift regulators or by the many nondepository purveyors of financial services who are not subject to such regulation.

As I view it, the heart of both bills deals with the new financial powers for bank and savings and loan holding companies. More precisely, in the case of S&L holding companies, we are dealing primarily with those that are currently termed multiple holding companies. This is because unitary S&L holding companies, as defined under present law, have no restrictions on permissible activities as long as their S&L subsidiary is eligible for the bad debt deduction under the provisions of the IRS code governing S&Ls. As a practical matter, most S&L holding companies are unitary in nature and their S&L subsidiary meets the bad debt deduction criterion. Thus, any bill purporting to expand the permissible activities of S&L holding companies in tandem with those of bank holding companies is hardly likely to be viewed from the thrift institution perspective as giving them anything of value.

The analysis of how S&L holding companies would fare under the Garn bill is complicated by the fact that this bill creates an entity termed the "qualified thrift lender", which a thrift institution can become by meeting certain criteria.

As long as a unitary S&L holding company subsidiary is a qualified thrift lender, no restrictions are imposed on its parent holding company permissible activities. An analogue to this for bank holding companies is provided by "consumer banks" also created under the Garn bill. These two new entities will be discussed in some detail after first reviewing the activities permitted for bank and S&L holding companies by the Garn and Proxmire Bills.

Before continuing, let me emphasize that neither the Garn nor Proxmire bill attempts to distinguish between or define a thrift institution vs. a commercial bank. Nor does either bill deal with who should regulate different types of depository institutions, whether the type be based on either charter type or asset composition. I would note, however, that the Federal Reserve Board would play the primary role in deciding on permissible activities not specified in the Garn bill for thrift holding companies whose subsidiary is not a qualified thrift lender. More importantly, the criteria used in both the Garn and Proxmire bills to determine whether the parent holding company should have unlimited activities may be viewed by some as a precedent for deciding which thrifts should be regulated by the Federal Home Loan Bank Board vs. one of the commercial bank regulators.

As a result, some of the previous testimony you have heard has focused sharply on the asset composition tests in the Garn and Proxmire bills designed to determine which thrift holding companies would have unlimited activities. This focus obviously indicates great concern regarding the precedent that such criteria might set with respect to who would regulate various types of thrifts. I will comment further on this issue at a later point in my testimony.

ACTIVITIES PERMITTED BANK AND S&L HOLDING COMPANIES

The major holding company issue involved in the Garn and Proxmire bills is the specific activities that would be authorized for all bank and S&L holding companies. With respect to the activities list, the Garn bill is more liberal than the Proxmire bill. In the case of the Garn bill, the activities list is limited if the subsidiary is not a "qualified thrift lender" or a "consumer bank." With respect to such activities, the Garn bill would permit bank and S&L holding companies of any type to engage in insurance underwriting or brokerage activities. It would also permit real estate investment, development, and brokerage. However, real estate investment and development would be limited to 5 percent of the holding company's primary capital; and construction activity would not be permissible at all.

The Garn bill would permit holding companies through Depository Institutions Securities Affiliates to deal in and underwrite obligations issued or guaranteed by the U.S. or individual states, sponsor and control an investment company, underwrite and sell investment company securities and underwrite notes secured by real estate mortgages. The Garn bill would also permit, on a nonsupervisory basis, bank holding companies to acquire thrifts and S&L holding companies to acquire commercial banks subject, however, to very restrictive geographic limits.

While the Proxmire bill authorizes some of the enumerated activities in the Garn bill for holding companies though Depository Institutions Securities Affiliates, it retains current limitations on insurance activities, which I suspect are the activities that bank holding companies would most like to have. It also does not permit bank holding companies to engage in real estate brokerage activities or acquire on a nonsupervisory basis S&Ls and vice versa. Both the Garn and Proxmire bills retain the Glass-Steagall Act restrictions with respect to underwriting corporate securities, which is the type of underwriting that large bank holding companies would obviously find the most lucrative of all. Since S&L holding companies are not subject to the Glass-Steagall Act restrictions, neither the Garn nor Proxmire bills are expansive with respect to the powers of S&L holding companies with respect to underwriting securities. In fact, they would ban securities firms that underwrite corporate securities from owning thrifts unless the latter were qualified thrift lenders in the cases of the Garn bill or thrifts meeting a rigid mortgage loan test in the case of the Proxmire bill.

Both the Garn and Proxmire bills would eliminate the present requirement that activities of bank holding companies permitted by Regulation Y of the Federal Reserve Board be a "proper incident" to banking; and the Garn bill would specifically permit the Federal Reserve Board to utilize the broader criterion "of a financial nature" as well as "closely related to banking" or "managing or controlling banks". The full degree to which this represents liberalization of bank holding company powers depends upon how the Federal Reserve Board interprets this new language, but the Garn bill does seem to encourage a liberal attitude on the part of the Federal Reserve Board with respect to any interpretation.

Under the Garn bill, the Federal Reserve Board would determine activities for S&L holding companies not specified in the statute under the same standards as for bank holding companies. The role of the Federal Home Loan Bank Board, as operating head of the FLSIC, would be of a negative nature. It could only prohibit or limit an S&L holding company in engaging in any of the activities permitted by the Federal Reserve Board.

While I endorse liberalization of bank and S&L holding company activities, I must note again that S&L holding companies do not gain anything under either bill although they fare better under the Garn bill and substantially better than under S.1609. The latter is the Treasury's bill on holding companies which eliminates the ability of unitary S&L holding companies to engage in unlimited activities. It does so without permitting any newly specified type of subsidiary S&L, as do the Garn and Proxmire bills, that allows the parent holding company to retain the unlimited activity privilege. As I noted in my introductory comments, almost all S&L holding companies are currently unitary and their subsidiary S&L meets the bad debt deduction test. Hence, they are not presently subject to any activity restrictions. Likewise, service corporation activities currently permitted by the Bank Board or state law are quite liberal.

I believe that the Garn bill, as relatively liberal as it is, is unnecessarily restrictive in limiting real estate investment and development to 5 percent of the holding company's primary capital and, even more so, banning construction activity. This is especially so with respect to thrift holding companies in the case of real estate investment and development since this is an area of thrift expertise, and thrifts and their holding companies clearly desire to participate fully in this area. In terms of parity as well as social benefits, bank holding companies should also have the right today to a liberal participation in this area.

IMPACT OF HOLDING COMPANY PROPOSALS ON NONBANK BANKS

The bank holding company proposals in these two bills deal with the issue of the "nonbank bank" phenomenon, which many have referred to as a loophole in the Bank Holding Company Act. A "nonbank" bank is one that fails to meet one of the two tests of a bank in the Bank Holding Company Act--either offering deposits that can be withdrawn on demand or engaging in commercial lending.

Should these so-called loophole banks be obliterated as is the approach taken by the Proxmire bill (except for banks that function solely as a trust company)? Or should a modified version of one of the "nonbank bank" variants be permitted, as would be the case with the Garn bill?

The "nonbank bank" issue is a high stakes one since such a bank is not subject to any of the activities restrictions embodied in the laundry list of Regulation Y as determined by the Federal Reserve Board under statutory language currently contained in the Bank Holding Company Act Amendments of 1970. Nonbank banks have been established by a wide range of firms, some of which are nondepository financial institutions but some of which are industrial or commercial firms.

The "nonbank bank" issue also comes up in the context of thrift institutions. This is because of thrifts' enlarged lending powers as a result of the Deregulation Act of 1980 and the Garn-St. Germain Act of 1982. These new thrift powers include commercial lending, as well as transaction account powers, although these remain limited with respect to checking accounts. Thus, thrifts now constitute, to a greater degree, a potential full service bank-type institution. Yet they can be chartered de novo or purchased by any firm in any industry according to the provisions of the current S&L Holding Company Act. I might add, however, that with respect to commenting on thrifts being more bank-like, we are dealing with a potentiality only. The reality is that the overwhelming number of thrifts have continued to operate as predominantly mortgage lending institutions with balance sheets not that different from what they were some years ago so that the ability of thrifts to operate like commercial banks remains much more potential than actual.

Many people view the ability of any firm to own what they perceive to be a bank-like thrift as a loophole in the same way as "nonbank banks" established by avoiding one of the two criteria of a bank defined under the Bank Holding Company Act. I might note, however, that the ownership of thrifts by a variety of other firms, including even industrial firms, has never raised any significant problems and that it can even be viewed as beneficial as a means of raising capital for a capital-depleted industry.

The Proxmire bill takes a more severe approach to the use of a thrift as a nonbank bank than does the Garn bill by requiring that a unitary S&L holding company be subject to the restrictions imposed on a multiple S&L holding company if an S&L does not have 60 percent or more of its assets in residential mortgages and certain related loans and investments.

In contrast, the Garn bill would permit thrifts to become "qualified thrift lenders" and, as such, retain complete freedom in activities engaged in by the holding companies that control them if the thrift meets one of two tests. The first is having not more than 25 percent of assets in commercial loans (including commercial mortgages). The second is having not less than 60 percent of assets in domestic residential real estate loans (including manufactured housing) and also equity positions and securities pertaining to these types of activities. Note that the second of the tests is more severe than the current requirement of meeting the bad debt deduction test as necessary for unlimited activities of the parent holding company, primarily because the qualifying assets under the bad debt deduction test include certain types of liquid assets.

VIEWING THE BASIC RATIONALE OF LIMITING ACTIVITIES OF BANK AND S&L HOLDING COMPANIES

I think that much of the testimony on permissible activities of bank and S&L holding companies that you have heard has not faced up to the basic question of why there should, in fact, be restrictions and where such restrictions should be drawn logically. The question is complicated by the fact that both of the bills amend the existing Bank and S&L Holding Company Acts rather than taking a fresh look at the purpose of these Acts.

Certainly, the major motivating factor behind at least the Bank Holding Company Act has been the desire to separate general commerce and banking. This is because of concern about the dangers of conflicts of interest and excessive concentration of resources perceived in a linkage between general commerce and commercial banking. Moreover, it has been suggested by some that the same concern is now relevant to thrift holding companies insofar as thrifts have been given commercial lending powers. The threshold question, however, is at what point a linkage between a bank or banking-like activity and general commerce leads to the perceived dangers enumerated above.

As we know, the Bank Holding Company Act and the S&L Holding Company Act, insofar as the latter restricts activities of multiple S&L holding companies, take an all-or-nothing view of the activities that should be permitted. Surprisingly, many of the activities not permitted currently are of a financial nature. In my view, this raises legitimate questions about the purpose of activity restrictions of the Holding Company Acts in their present form.

That these are legitimate questions is illustrated by the fact that it is difficult to see what dangers have arisen from the so-called "nonbank bank" loopholes under the current Bank Holding Company Act, or, for that matter, the current S&L Holding Company Act, the latter of which does not restrict firms engaged in general commerce from chartering or buying an S&L, regardless of what its commercial lending powers may be. No one has yet demonstrated adverse effects of the currently existing nonbank banks as far as the public interest is concerned. I do recognize, however, that the nonbank bank, given its unlimited parent company activities, has led to a lack of parity with respect to the activities permitted bank holding companies as subject to the Bank Holding Company Act.

In fact, one of your previous witnesses gave convincing evidence that consumer-type banks owned by industrial and other types of firms have been beneficial to consumers despite a linkage between general commerce and commercial banking in some of these cases. In this respect, the Garn bill legitimizes in modified form one of the "nonbank bank" loopholes by creating consumer banks.

In all candor, I think that the Bank Holding Company Act and, to a more limited extent, the S&L Holding Company Act have become a battleground over which product lines bank and S&L holding companies should be permitted to offer. What we are witnessing is, in reality, a turf battle. What I am suggesting here is that the Bank Holding Act may well be more a force for suppressing competition than for fostering it.

I suspect that few would feel that an ownership linkage between General Motors or IBM with Citibank would be in the public interest because of the potential for serious conflict of interest problems. However, we continue to draw arbitrary and Byzantine distinctions with respect to permissible activities under the Bank Holding Company Act (and, with respect to multiple S&L holding companies, under the S&L Holding Company Act). The broadening of product lines for all bank and S&L holding companies would be a large step toward creating more parity with what nonbanking firms can do and would serve the public interest. The Garn bill takes a more aggressive stance in this direction although, as I have noted, this does not provide benefits to the dominant form of S&L holding company -- namely those of a unitary nature, although if the latter meet the "qualified thrift lender" test, they retain their current ability to engage in unlimited activities.

What this suggests is that competition might be better served by a Bank Holding Company Act and a Savings & Loan Holding Company Act that hinged on judicial findings of a meaningful lessening of competition or meaningful possibilities of injurious conflicts of interest as a result of breaching the wall between general commerce and commercial banking. As for linkages between commercial banks (including thrifts) and nonbank financial firms, I certainly see no basis for presuming *a priori* that these are anti-competitive, or should be automatically banned. I see no reason why any activities of a financial nature should not be subject merely to the same antitrust laws as apply generally to mergers or price-fixing situations.

I would like to comment here briefly on the provision in the Garn bill that would restrict the ability of bank and S&L holding companies to acquire other depository holding companies where the result is a holding company that has over 0.3 percent of total domestic deposits and 25 percent of its consolidated capital invested in any one of the permissible activities for such a holding company. It has been stated that this would affect the 25 largest bank holding companies; and it may well be that some S&L holding companies could be affected by this as they continue to grow.

I do not see why this particular rule should be required if there is no significant lessening of competition in a product area in a significant geographic area of the country since, otherwise, we are merely restricting financial acquisitions or degree of participation in certain financial activities because of size _per se_ on a national basis. Any concern about concentration in financial activities should apply only where significant competition would be eliminated. Otherwise, the impact of focusing on concentration is likely to be anti-competitive as a result of reducing the actual or potential number of competitors in many important financial product areas.

ROLE OF QUALIFIED THRIFT LENDER

The definition of a "qualified thrift lender," as given earlier in my testimony, is of key importance in the Garn bill. The option under the Garn bill of using an asset composition test that permits a qualified thrift lender to have less than a specified percent in commercial loans (including also commercial mortgages) is not in my opinion restrictive. Nonetheless, while the 25 percent specified in the Garn bill for commercial loans needs further examination, a depository institution that engages in limited commercial lending would be unlikely to create problems with respect to the public interest if its parent holding company can engage in unlimited activities.

I am aware that considerable controversy has occurred with respect to using the qualified thrift lender concept based upon the two Garn bill asset composition tests. One school of thought argues that commitment to mortgage lending is the relevant factor, taking into account, however, liquid assets and other assets as qualifying for the test. The other school of thought argues that the degree of commercial lending is the only meaningful criterion.

It needs to be emphasized that the concept of a qualified thrift lender is relevant in the context of the Garn bill only with respect to retaining the currently unlimited activities permitted unitary S&L holding companies. It is not directly relevant to the difficult issue of where to draw the dividing line between a thrift institution and a commercial bank. The latter issue would only be relevant if the qualified thrift lender asset composition test were to be used to determine who would regulate the institution. But the Garn bill does not address the question of at what point a depository institution becomes a thrift or commercial bank for purposes of regulation; nor, given the number of controversial issues that the Garn bill already tackles, do I believe that it should address this question.

I know that attempts to define thrifts vs. commercial banks are certain to raise difficult semantic issues. The fact is that a large percentage of commercial banks as presently chartered have relatively small commercial loan portfolios. Conversely, many commercial banks have substantial mortgage and real estate-related investments which, when combined with the inclusion of liquid assets, and, taking into account large mortgage banking operations, would meet what many perceive as primarily a thrift test. Similarly, some old-line savings banks have portfolios that raise thorny issues about whether they are a thrift or a commercial bank if one were to use only a mortgage-based definition.

What I perceive here is that the concern over the asset composition test for a qualified thrift lender reflects differing philosophies over the direction in which thrifts should go and that this is being played out over the issue of having unlimited permissible activities for a thrift holding company.

In assessing whether the qualified thrift lender concept should be endorsed, regardless of the test used to define this concept, I have to note the basic premise of the Treasury bill, S.1609. This premise is that parity between competing depository holding companies implies that the lack of any restriction on activities for unitary S&L holding companies is indefensible since unitary bank holding companies currently lack this privilege. I reject this premise since thrifts still remain very much of a stepchild to commercial banks in terms of use of broad asset powers and because of the continued dominance of the latter in commercial lending. Rather than adopt the Treasury Department's position, I would prefer to move all bank holding companies closer to S&L holding companies in terms of activities permitted rather than curb the activities of S&L holding companies.

I believe that, with a liberal list of activities permitted all bank and S&L holding companies, we will have taken a long step toward moving bank holding companies close to S&L holding companies in terms of activities. Given such a list of activities, I believe that the Garn bill's two-pronged definition of qualified thrift lender and the unlimited activities that flow from this for parent thrift holding companies is defensible and in the public interest.

ROLE OF CONSUMER BANKS

An analogue to qualified thrift lenders is provided in the Garn bill for bank holding companies by the equally new concept of "consumer bank". These latter could invest up to five percent of assets in small business loans and retail inventory financing but could otherwise engage in no commercial lending. As with holding companies controlling qualified thrift lenders, those controlling consumer banks would also not be subject to any activity constraints. Thus, consumer banks, too, could be owned by any entity.

Note that there is a lack of symmetry betweeen consumer banks and qualified thrift lenders in terms of their asset powers, with qualified thrift lenders permitted to have a larger percentage of their assets in commercial loans as well as a broader range of such loans than consumer banks. On the other hand, qualified thrift lenders that are federal S&Ls would continue to be subject to the restrictions on offering checking accounts noted above.

The consumer bank is a more unique innovation and tracks much more closely with one of the two nonbank bank variants flowing from the Bank Holding Company Act definition of a bank. It does allow industrial or commercial type firms to provide additional competition in the financial services area without the dangers perceived by many in a linkage between general commerce and commercial banking.

In this sense, it is difficult to argue against consumer banks; and I endorse them. However the authorization of federally-chartered consumer banks, if this should be accompanied without expanding substantially the powers of full service bank holding companies, would aggravate the disparity between such full service bank holding companies and their nonbank holding company competitors who could own consumer banks and have no restriction on their permitted activities in being able to compete on a reasonably equal basis. I assume, therefore, that commercial bankers who support the consumer bank would base this support contingent upon a substantial broadening in activities permitted bank holding companies.

HOW CAN MUTUAL THRIFTS TAKE ADVANTAGE OF NEW PERMISSIBLE ACTIVITIES?

The problem of mutual thrifts that do not operate under a holding company form is aggravated by both the Garn and Proxmire bills with respect to pursuing activities contingent upon having such a holding company form. The new powers conferred on bank holding companies can be exercised by all commercial banks, which, by virtue of being stock institutions, can assume a holding company form if they have not already done so.

Hence, it is important that mutual thrifts can assume these activities through adequate service corporation authority, certainly more than the three percent currently allowed federal S&Ls. In this regard, the impact of the Garn bill on service corporations is ambiguous and needs substantial clarification. Likewise, proposals for designing holding companies for mutual thrifts, which have been put forth, should be examined carefully by regulatory authorities and should certainly be permitted in any bill passed by Congress as an additional mechanism for exercising various powers.

It needs to be recognized, however, that some of the activities conferred on bank and S&L holding companies by the Proxmire and Garn bills can well be exercised directly by commercial banks and thrifts with greater efficiency than either through the holding company or even service corporation route without detriment to safety or soundness. Insurance brokerage is a good example of this. Careful thought should be given to additional types of activities where this can be done on a direct basis within the depository institution corporate shell itself.

REGIONAL AND INTERSTATE COMPACT BRANCHING AND OTHER INTERSTATE ISSUES

The Garn bill would clarify the ability of commercial banks to engage in interstate branching through state compacts that would require affirmative action on the part of each state involved. Unfortunately, as many seem to agree from their reading of the bill, the inclusion of thrifts in this provision of the Garn bill appears to also require affirmative state action for federal thrifts and, thus, raises questions about whether this annuls the Bank Board's present authority to permit nonsupervisory interstate branching for federal savings institutions. The Bank Board's authority should not be thrown under a cloud by the present wording of the Garn bill. As a result, I believe that all references in this section that would apply to federally-chartered thrifts should be deleted.

While I favor a phasing in of interstate branching, I am concerned that the motivation of interstate compacts on branching may be to "shut out" other states in which it is perceived that banks (or thrifts) are quite large and, hence, more likely to acquire banks (or thrifts) in other states if they are permitted to be included in interstate compacts. This could lead to a situation in which such states as New York, Illinois, and California are shut out of compacts, likely permanently. It would be more conducive to an orderly phase-in of interstate branching if, for bank or thrifts that are federally-chartered, the adoption of interstate compacts would trigger, under federal law, unlimited reciprocal branching (i.e., involving federally-chartered depository institutions in all states) after a fixed period of perhaps three to five years.

It would make sound economic sense also if interstate branching in interstate metropolitan areas were mandated for federally-chartered depository institutions within perhaps one year under the provisions of this bill. This should also be part of a phase-in of interstate branching for federally-chartered depository institutions generally over a number of years.

INTEREST ON DEMAND DEPOSITS AND RESERVES REQUIRED BY THE FEDERAL RESERVE

The removal of the ban on payment of interest on checking accounts is long overdue. It is a logical extension of rate decontrol and recognizes that the payment of explicit interest on NOW and Super-NOW accounts has proven beneficial. The interest rate ceiling should be entirely removed from checking accounts having the same $2,500 minimum as for super NOW accounts, with the 5 1/4 percent ceiling for NOW accounts used only for checking accounts under $2,500. Also, the same phase-out of NOW account ceilings mandated by the DIDC should apply to checking accounts.

This provision of the bill is not effective until 180 days after enactment, presumably to provide some breathing space for smaller banks that would find their costs raised more than for large commercial banks because of the greater importance of demand deposits for small community banks.

It needs to be emphasized that the provision in the Garn bill that would direct the Federal Reserve Board to pay interest monthly on reserves required to be held against money market deposit accounts, super NOW accounts and any new transaction accounts authorized by the DIDC after December 1, 1982 is in part an attempt to relieve the unfairness inherent in not imposing reserve requirements on money market funds but imposing such requirements on depository institutions that offer money market fund type accounts. But the impact would also ease any transitionally adverse impact on profits of having to pay interest on checking accounts. Ideally, the Federal Reserve Board should also pay interest on total reserves against checking accounts, especially since the ban on paying interest on checking accounts would be removed.

OVERRIDE OF USURY CEILINGS

This section of the Garn bill preempts state interest rate ceilings on business, agricultural, and consumer loans subject to a three year period in which states have a right to override federal preemption. Complete federal preemption with respect to interest rate ceilings on assets would, of course, be preferable, especially since rate deregulation on the liability side of the balance sheet of depository institutions has already occurred and is raising the interest cost of obtaining funds. I recognize, however, the problems involved in advocating complete federal preemption.

THE ISSUE OF COMMITMENT OF THRIFTS TO HOUSING

Neither the Garn nor Proxmire bill address directly the issue of whether thrift institutions should be committed to housing. Nonetheless, the Garn-St. Germain Act of 1982 did specify that the new powers therein conferred on thrifts were meant to foster the role of thrifts with respect to housing. Also, by requiring that unlimited activities for unitary S&L holding companies and general interstate branching of S&Ls be contingent upon meeting the bad debt deduction requirements, there was a presumption of some degree of commitment to housing in order to obtain certain privileges not available to banks or bank holding companies.

The Proxmire bill takes a stronger view than does the Garn bill that thrifts should be committed to housing by not endorsing the concept of a qualified thrift lender and by applying an asset composition test to unitary as well as multiple S&L holding companies that requires at least 60 percent or more of its assets to be in residential mortgages and certain related loans and investments. This is more severe than meeting the current IRS bad deduction test.

It is my view that the thrift industry will continue to be strongly committed to housing regardless of asset composition tests imposed on thrift subsidiaries of holding companies or the nature of the IRS bad debt deduction applied to individual thrifts. The bulk of the thrift industry has its roots and commitment in housing; and it has an expertise in this area that thrifts recognize is highly valuable. The fact that thrifts originated about 46 percent of home mortgages in 1983 and were also the major multi-family residential lenders bring home this point.

The fact is that residential mortgages represent a much larger percentage of the loan market than do consumer and business loans; and the consumer and business loan markets are already dominated by strong and entrenched competitors. Even if thrifts wanted to shift significantly out of housing credit, they could not do so as a practical matter. And it is clear that the large bulk of thrifts are using new lending powers to engage in a modest diversification, at most, outside of housing credit that is beneficial to their safety and soundness.

Under the circumstances, I see no reason why thrift institutions need to be subject to rigid tests in order to gain certain perceived advantages. I believe that the marketplace gains by reasonable fluidity in what various financial institutions can engage in and that thrifts need to be judged increasingly in their housing role not by simple asset composition tests but also by their role in the secondary mortgage market.

SUMMARY

In my comments above, I have attempted to articulate a position that would continue the pace of financial deregulation in a reasonably equitable and straightforward manner. I believe that all depository institutions -- both banks and thrifts -- should be permitted to compete in a widening range of products over a widening geographic area. This would provide greater parity with the banking-like powers of firms that are not regulated by regulators of depository institutions. I need not belabor the obvious facts that brokerage houses, insurance companies, other nondepository financial institutions, and even industrial firms are getting increasingly into the financial services area and competing head-on with depository institutions without the shackles that the latter labor under. It is important under the circumstances that the Federal Government moves ahead to provide a more equitable, but still supportive, continued deregulation of financial markets.

Consistent with this, I have endorsed a broad approach to bank and S&L holding company activites. Contingent upon such a broad approach, I endorse the creation of "qualified thrift lenders" and "consumer banks" to further promote competition and the public interest. With respect to widening geographic competition, I have called for a phase-in of interstate branching for both federally-chartered thrifts and banks.

I believe that none of this will have an adverse impact on the commitment of thrifts as a whole to mortgage lending and housing. In fact, we have been witnessing a broadening of participation of the entire financial community to housing as a result of securitization of mortgages and the spectacular growth of the secondary mortgage market. This has occurred concomitant with financial deregulation; and there is every reason to believe that further financial deregulation, guided by Federal legislative initiatives, will further benefit housing.

Senator **Gorton**. Thank you, Mr. Kaplan.

Both of you are experts in counseling financial institutions about mergers and acquisitions. That kind of activity has increased and there seems to be more and more interest in interstate operations. What are the reasons behind the decision of a depository institution to acquire or be acquired by another such institution when it is the notion that there are no significant economies of scale?

REASONS BEHIND ACQUISITIONS OF DEPOSITORY INSTITUTIONS

I'd like to get both of your thoughts on that double-headed question. Mr. Golembe, do you want to start?

Mr. **Golembe**. Well, it is true, Senator, that in the past most studies have shown that economies of scale are not significant above a fairly small bank size. I'm not familiar with the recent literature, but there are certain economies of scope, so-called—the ability to offer a wider variety of services—which do result, after acquisitions, in efficiencies and improvement in net earnings. Because we're really not talking about the old banking functions necessarily—one bank taking over another—but about institutions coming together and able to offer a wide variety of services that are related to banking.

Senator **Gorton**. Mr. Kaplan.

Mr. **Kaplan**. I would build on that and suggest that in particular looking at thrift institutions in the last several years the stimulus for many of the mergers we have seen is the fact that the modest size of the average thrift simply doesn't allow it the base on which they can undertake to start offering the various new powers that have been provided in the last several years.

Complexity is a watchword here and the increase of size accomplished through mergers is an essential ingredient and, candidly speaking, in many cases these mergers have been undertaken defensively to increase the capital base. This allows the institutions the financial resources and time to develop the technical expertise to offer these services.

Senator **Gorton**. What do you foresee as the future for relatively small community banks?

Mr. **Golembe**. I see a good future for the relatively small community bank. I really have no concern, Senator, over their ability to compete with larger institutions, by and large. We have seen this work out very well in a State like California, for example, where the number of smaller community banks keeps increasing even though they are competing with either the first or second largest bank in the country, depending on which day you happen to make the comparison.

I really have great confidence in the ability of the well-managed community bank to survive and do well.

Mr. **Kaplan**. Again, I would echo that and I think the key is the phrase "well-managed." The evidence is clear that smaller institutions that are properly managed can do quite well. The evidence further suggests that newly chartered institutions in their early years can do quite well. Therefore, I share Carter's view that there is a continued place in the market for smaller institutions.

Senator GORTON. How will both the nature and the quantity of merger activity be affected if Congress enacts no substantive legislation this year? More mergers, fewer mergers, different kinds?

Mr. KAPLAN. On the thrift side, we are already seeing that, while the pace has slackened from the number of mergers that were consummated in 1981 and 1982, there still remains a significant number. We are coming off of a peak experience.

The fundamental pressures that drive institutions to seek out mergers, whether it be in search of economies of scale, the ability to offer more complex new products, or simply a defensive strategy in terms of dealing with weakened capital position—those pressures and those motivations are still there. So I would expect that we will see a continuation of the pace of mergers.

Mr. GOLEMBE. And I think I would agree generally, focusing particularly on banking. If the supposition is no substantive legislation, one would assume that the current pace would continue. I think the data show that there are, still, more new banks coming into the banking system than banks going out through merger, and that the total number of banks is increasing. At least it has been in recent years. If there were substantive legislation, a lot would depend on the nature of that legislation. If it had to do with reducing or eliminating geographic constraints, I think you would see a considerable increase in the number of mergers. Here, today, we are talking about product constraints and I wouldn't expect any change in such constraints to have nearly as great an effect on mergers as legislation reducing or eliminating the geographic boundaries.

Senator GORTON. What effect does continuing economic growth and the reaction with the deficit likely to have on interest rates and margins within the next year or so? Mr. Golembe, do you want to start on that one?

Mr. GOLEMBE. I'm not your best witness, Senator, on forecasting interest rates. I simply—I guess I will stick with that. I do not know what interest rates are going to be or whether they are really related to the deficit. What might happen is something I can't comment on.

Senator GORTON. Mr. Kaplan, do you want to take that on?

Mr. KAPLAN. I don't think I'd touch that either, but I would simply say that if we do find ourselves in an environment of higher interest rates, I think that will certainly produce an increase in merger activity.

Going back to your earlier question in the thrift area, spreads between portfolio yield and cost of funds are fragile and the capital base is thin and I think that increased merger activity would be one of the consequences we would observe rather early in the process.

Senator GORTON. Mr. Golembe, you make the case that the banking industry is highly competitive and far less concentrated than the insurance or securities industry?

Mr. GOLEMBE. Right.

ANTICONCENTRATION PROVISIONS IN THE GARN BILL

Senator **Gorton**. Does this argue in favor of the anticoncentration provisions in the Garn bill?

Mr. **Golembe**. The anticoncentration provisions in the Garn bill, as I understand them, essentially provide that the largest 25 banking organizations couldn't acquire very large insurance or securities firms, at least if as a result the bank holding company would have more than 25 percent of its capital in one of those activities.

I think those provisions in the Garn bill, in the first instance, have a kind of perverse effect and would be more favorable to the very largest banking organizations than to those not quite as large as the very largest. So within that grouping, it would have a perverse effect.

Senator **Gorton**. Would you explain that perverse effect?

Mr. **Golembe**. I'm guessing, but if I understand it correctly, Bank of America or Citicorp could acquire a larger nonbank institution than let us say—I don't know who is at the bottom of the 25——

Senator **Gorton**. The bottom of that list of 25?

Mr. **Golembe**. Yes. Within that list of 25, it would have a perverse effect. It would favor the largest rather than the next to largest, so to speak. But I believe the real question is the abuse of market power, and that is a problem that may exist with banks of very large size, or very small size, or anywhere in between. The antitrust laws are directed toward that problem. Philosophically and intellectually, I never like to deal with questions of prohibitions based simply on size, with no other factor taken into account.

Senator **Gorton**. But that implies a satisfaction with both the state of the antitrust laws and the state of its enforcement.

Mr. **Golembe**. Yes; it does imply that by and large. This is not to say that any law can't be improved, but I would like to see attention, as I said, directed at the abuse of power in individual markets and not necessarily on whether the institution abusing its power is large or small.

TRANSACTION ACCOUNTS

Senator **Gorton**. You say that the special position or uniqueness of banks has largely disappeared because other institutions can now offer transaction accounts. Would it be an appropriate criticism of that position to state that the practical significance of transaction accounts outside of banks is overstated and, in addition, doesn't bank access to borrowing privileges of the Fed confer an additional type of specialness on banks?

Mr. **Golembe**. Well, I would certainly agree starting at the end there—that banks are special. They are simply not as special as they used to be, and if we look toward the future and to what technology is going to bring us, I doubt that they will be anywhere near as special in the future as they are today.

Now 10 or 20 years ago I think it could be said appropriately that commercial banks were more or less unique organizations. As a matter of fact, the Supreme Court said that in 1963 when it said that commercial banking was a distinct line of commerce. But that was based primarily on the belief, and fact, that banks could offer something that no one else could offer, namely, the transaction account; and that also they were quite important as business lenders.

Today, with thousands of thrift institutions offering transaction accounts, that uniqueness has disappeared. Banks today are certainly not the preeminent and probably not the leading providers of business credit, taking into account the commercial paper market, commercial credit companies, and so forth.

So to a very considerable extent, in my view, what was a rather unique industry 10, 15, or 20 years ago, no longer is. To be sure, it still is entangled with Government—reserve requirements, membership in the Fed, FDIC, and so forth. But access to the Fed has been extended to a wide variety of institutions in addition to commercial banks, if they provide transaction accounts. I don't know if that is a sufficient answer and covers your points.

Senator GORTON. I think it does.

Mr. Kaplan, you point out that the Garn bill doesn't address the issue of who should regulate thrifts and banks. Which is the cart and which is the horse in this respect? Shouldn't we look to see what institutions are given what powers before we decide who regulates whom?

Mr. KAPLAN. I think that that's a correct way to approach the question. My point in my testimony was just to identify the issue because I think folks are confused about that and the question of who should regulate certainly is an undercurrent in the testimony that you have heard previously and I expect in the testimony that you will hear as you go forward.

Senator GORTON. You mentioned that thrifts and commercial banks are different from one another. What are those basic differences and how would you define a bank as against the definition of a thrift?

Mr. KAPLAN. Well, I think we can all agree that the line has blurred. Yet if we look at the evidence over time as shown by the assets that have accumulated on the balance sheets of the institutions, the simply fact is, notwithstanding the deregulation that we've already experienced, the thrift industry is still the predominant residential home mortgage lender in the Nation. I suspect and I suggest in here that it is my view that, even with the continued deregulation, the thrift industry is going to stay primarily focused and committed on the residential mortgage marketplace.

The deregulation is important, however, to give the thrift industry the flexibility to even out the cycles and to respond to changes in the demand for financial services, but I don't see anything on the horizon that suggests that thrifts are going to abandon what has been their traditional focus. I don't know if that gets to the question or not.

Senator GORTON. Well, it does in part. I was really asking for your abstract view of whether or not the two should be defined differently in the law, whatever you think as a practical matter that would do? Would you define them differently as a matter of law?

Mr. KAPLAN. Well, I guess the way I would comment on your question is that I'm concerned that the way we achieve parity is not by taking powers and flexibility away from the thrifts and their holding companies and regulating down but rather providing a broadening in activities of bank holding companies and thrifts to move them up to achieve parity and I guess I would approach it that way.

UNDERWRITING CORPORATE BONDS

Senator GORTON. OK. Last week Treasury Deputy Secretary McNamara said that he thought banks should be permitted to underwrite corporate bonds but that the administration has not proposed it because it doubted that Congress would pass such a proposal.

Do you believe that banks should have this underwriting power? That's to you, Mr. Kaplan, at this point.

Mr. KAPLAN. Not at this point. I think that that would be a step that might be too large at this juncture.

Senator GORTON. Mr. Golembe.

Mr. GOLEMBE. I would say that this is the proper point, and that it would not be too large a step at this juncture. However, realizing the practical problems of getting anything like that enacted, I simply didn't mention it in my testimony.

Senator GORTON. But in theory you would open up the bank area if that were practical?

Mr. GOLEMBE. Yes, I would.

Senator GORTON. Would you go beyond that and open it up to the underwriting of corporate equities?

Mr. GOLEMBE. Yes.

Senator GORTON. Mr. Kaplan, in your discussion of the special problems of dealing with mutual thrifts, you argue that some powers could be permitted to such institutions directly. By implication then, other powers could be granted to depository institutions only as a protective device of a separate subsidiary of a holding company. Again, if it were shown that the holding company structure was an easily pierced veil, would you reverse your proderegulation stance at least with respect to some powers and is that a concern of yours?

Mr. KAPLAN. I'm not sure if I understand the question, but let me comment. My concern is that the large portion of the thrift industry today remains mutual and that I expect that it will continue to be largely a mutual dominated industry for many years to come. The transition toward stock charter is continuing, but at a pace that would leave the industry primarily mutual for some time.

There simply has to be a way for an institution that either cannot or chooses not to become stock chartered to be able to obtain the new powers. I have suggested that one route is to further liberalize the availability of those powers through the service corporation vehicle. I don't believe we achieve the desirable end if institutions are forced to convert to stock in order to achieve these powers.

Senator GORTON. I'd like to thank you both for being here. It may very well be that we or the chairman will have some additional questions because your testimony has been so helpful which in that case we will submit them to you in writing very promptly. But we do appreciate your willingness to testify and help us with this difficult issue.

Mr. GOLEMBE. Thank you very much, Senator.

Mr. KAPLAN. Thank you.

[Response to written questions follows:]

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CARTER H. GOLEMBE

April 19, 1984

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and
  Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Garn:

Thank you for your letter of April 10, 1984, commenting on my testimony before your committee last month. You have asked that I submit additional comments on statements by insurance witnesses to the effect that if banking organizations are permitted to engage in new activities "improper tie-ins will result and, in any event, ... banks have a poor record in those areas where they now compete -- for example credit life insurance."

Quite candidly, I have always found the tie-in argument made so frequently by insurance industry spokesmen to be both puzzling and frustrating. It is puzzling because it is clearly invalid on its face, and yet the argument persists. It is frustrating because the form in which it persists is not susceptible of proof or disproof.

I take it there is no argument over the fact that "improper" tie-ins, by which I assume is meant coercive tie-ins, are illegal under the antitrust laws and under the Bank Holding Company Act. Nor does there seem to be much doubt that the record is virtually devoid of violations of those laws. For most persons, those facts alone should be a sufficient response.

As we all know, however, the "improper tie-ins" argument is put on a different basis than law or fact. It is argued that when insurance or other financial services are offered by banking organizations, customers will somehow feel themselves compelled to "voluntarily" make such purchases in order to curry favor with the banks or because of fear of retaliation by the banks. The frustrating aspect of this kind of argument is that it requires an assessment of the mental state of customers at the times they enter into transactions. And who is to say what passes through the mind of any individual customer when he or she contemplates purchasing or not purchasing an additional service from a bank? No one can say -- no one will ever be able to say -- that somewhere in the tens of millions of transactions that must occur each year there will not be someone, somewhere, who may decide to purchase insurance or any other financial service for misconceived or illogical reasons. And even if we could identify one or several such cases, what is this supposed to prove?

Cold economic logic suggests that such illustrations must be *de minimis* and that the "improper tie-ins" argument, even when put in the form described above, makes little sense. The reason is that the underlying assumption -- indeed, the necessary assumption for such an argument -- is that the bank occupies a monopoly position in the market when it comes to the granting of credit (to which it presumably "ties" other services) or is otherwise so uniquely positioned in the market as to be both capable and willing to injure any potential customer who might have the temerity to seek financial services from other sources. But we know, of course, that the banking industry is highly competitive; indeed, that the industry serving as a source of credit for individuals and small businesses -- where, presumably, the tie-ins argument has any relevance -- extends much beyond banking. And certainly it does not make good business sense in the long run for a bank, operating in a competitive environment, to attempt to exert pressure, subtle or otherwise, on individual customers, to say nothing of the danger of violating the law.

The latter statements could, of course, be supplemented with extensive tabulations on the nature and extent of competition among banks and among all financial institutions offering credit services. Surely this has been done many times already and I assume that you would not want me to further burden the record in this respect. Actually, I would think that one need go no further than point out, as I am sure many other witnesses already have, that a study commissioned last year by the American Insurance Association and done by the highly respected firm of Coopers & Lybrand concluded that "deposit-taking institutions generally do not dominate their markets to such an extent that substantial market power could be used to force their way into the markets by compelling the purchase of an insurance product by their depositors." (*Expansion of Banks Into Insurance*, p. vii)

The other statement by insurance industry spokesmen on which you requested comment deals with the purported "poor record" of banks when it comes to providing insurance, particularly credit life insurance. Although I have not had an opportunity to examine the statements of the various witnesses in detail, I assume that the reference here is to prices charged by banks or profits made through insurance sales

-- either or both of which are thought to be excessive. I do not claim any special expertise in the structure or operations of the insurance industry. But if the argument is that which I described, it seems to me to make little sense, on its face.

First, if there are indeed "monopoly profits" available in any aspect of the insurance business, then this is clear and convincing evidence of the need for more competition, not less. Indeed, I would assume that there are in fact monopoly profits in the insurance business and that opposition to the entry of new competitors, whether banks or anyone else, is based fundamentally, and understandably, on the desire of those already in the business to protect those profits. One would have to stand logic on its head to believe that the strenuous opposition by the insurance industry to bank competition is based on a desire to protect a market and a pricing structure which yields nothing more than a bare, competitive profit.

I do not know whether individual banks now offering various forms of insurance services are doing a good or a poor job. Certainly on the fragmentary evidence available there is as much in the record to support the former as the latter; the provision of life insurance for many years by savings banks in a convenient and inexpensive form for customers is certainly an illustration of the former. The point is that the evidence is fragmentary, and it is fragmentary because banks or bank holding companies are severely limited in the nature and range of insurance activities in which they may engage. And this is true, of course even of credit life offered by banks which, by law, is restricted to the loans made by banks.

My point is that one cannot really assess the competitive impact of bank entry until there has been bank entry, and that is far from the case today. When it becomes possible for banking organizations to compete across the full range of insurance activities, I am convinced, as I said in my formal statement to your committee last month, that the ultimate beneficiary will be the public. Protectionism, whether applied to banking or to any other economic activity, has never served the interests of anyone except those who offer or produce the protected product.

I hope that the foregoing is responsive to your questions and will be of some use.

Sincerely yours,

CHG/pai

Senator Gorton. Our second panel will consist of George Benston from the University of Rochester, Robert Eisenbeis from the University of North Carolina, Paul Horvitz of the University of Houston, Edward Kane from Ohio State University, George Kaufman from Loyola University in Chicago, William Lovett from Tulane University School of Law, and Almarin Phillips from the Wharton School of Economics.

Mr. Benston, we will begin with you and, as I said to the earlier group, your entire written statements will be included in the record as if read.

STATEMENT OF GEORGE J. BENSTON, PROFESSOR, GRADUATE SCHOOL OF MANAGEMENT, UNIVERSITY OF ROCHESTER, ROCHESTER, N.Y.

Mr. Benston. I'm going to take your suggestion; considering that I'm not associated with anybody except a university, I'll say what I believe without concern with whether it's politically desirable or not.

Senator Gorton. That's why you're here.

Mr. Benston. Basically, as you know, the present situation is the result of the legislation passed in the 1930's—the prohibition of interest on demand deposits, the Glass-Steagall Act, the separation of the commercial and investment banking, and constraints on letting banks get new charters. But there were also things that were not changed at that time which are very important; namely, legislation restraining branching was maintained, although there was great pressure to change it at that time, and the deposit insurance agencies were established. The last is giving us a lot of trouble.

Basically, it all worked quite well as long as the economy was declining and, later, stable, and interest rates were low and not very volatile.

But given the inflation-induced higher interest rates and the technology that allowed people to move funds around very easily, it became advantageous for entrepreneurs to seek to develop new products and for consumers to try to get those new products so they could get a market rate on their funds and get other services. This caused, as we know, the situation in the 1930's to break down.

Now before one goes about and tries to change all this, I think it would be useful to try to understand why we have banking regulation at all. If we look around the world and over history, we find that banks have been regulated in almost all countries at almost all times since we've had commercial history. Before one does away with regulations, if one could do such a thing, the question is, why did this happen and is it relevant to us in the United States in the 1980's?

I tried to do this in a paper that I prepared originally for the Treasury Department and since has been published by the Journal of Bank Research and I will put it in the record so I don't have to go over it in detail.

Senator Gorton. It will be included in the record.

[The following article is supplied for the record:]

Federal Regulation of Banking: Analysis and Policy Recommendations

George J. Benston
Professor of Accounting, Economics
and Finance
Graduate School of Management
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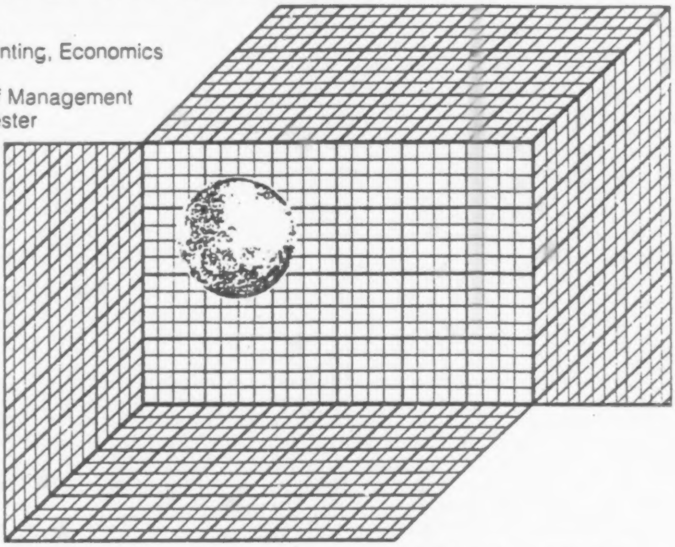

ABSTRACT

Banking has been regulated over the centuries in most countries. The reasons for this pervasive regulation are delineated and analyzed as a basis for suggested changes. Among the nine reasons specified, the most important, historically, was to enhance taxation. This reason and five others discussed are no longer valid, or even are dysfunctional. Only deposit insurance, money supply control and protection of some banking services supplies are currently meaningful reasons for regulating banking. Several suggestions are made that should make these regulations more efficient. Otherwise, unless one wants to protect producers from competition, most laws that regulate and constrain banking should be repealed.

Banking is and has been one of the most regulated of industries. In almost all countries and at all times since the establishment of banking, governments have imposed controls on the institutions, even when most other businesses were free to operate, subject only to the statutes and other general rules of law. In the United States, the extent of regulation has ranged from the free entry banking period of the 1800s, when banks still were supervised and required to maintain specified reserves against the notes they issued, to the extensive controls imposed in the 1930s. The Depository Institutions Deregulation and Monetary Control Act of 1980 removed some regulatory restrictions (e.g., allowing thrift institutions to make consumer and business loans) while imposing others (e.g., requiring noninterest bearing reserves for all chartered institutions' demand and similar deposits). But as increased nominal interest rates raised the opportunity cost of holding money as deposits at the regulated, chartered financial institutions and as the cost of electronic and telephonic fund transfers declined, the development of products and services designed to avoid the regulations and competition by unregulated providers of financial services increased. It is imperative, therefore, to determine whether the present regulatory structure best serves the public interest and should be extended to all providers of financial services (the level playing field simile), whether regulations should be removed from all providers (perhaps a free-for-all would be a parallel simile), or whether some other restructuring and/or consolidation of the regulations and regulators would be desirable.

However, before changes in the existing order are recommended, the reasons for the past and present regulatory situation should be delineated and analyzed. In this regard, two considerations are likely to be important. First, there were reasons for regulating financial intermediaries more than almost any other industry; should some regulations be removed, the conditions that gave rise to them might re-occur, to the detriment of some people. It is best if the lessons of history are not relearned. Second, the present situation in the United States may make previously relevant regulations no longer applicable or useful. These vestigial regulations impose burdens on society without any compensating benefits. The bulk of the paper is directed toward identifying the antecedents and contemporary relevance of the present set of regulations and regulatory agencies.

The analysis presented in the next section leads to the conclusion that most of the historical reasons for regulating financial institutions are no longer relevant (if they ever were) to our society. These reasons (which are discussed below) include taxation of banks as monopoly suppliers of money, the prevention of centralized power, bank solvency and the effects of failures on the economy, the provision of banking services as a social goal, support of housing and other attempts to allocate credit as social goals, and the prevention of invidious discrimination and unfair dealing against persons. What is needed, therefore, is abolition of most federal regulation. Indeed, with the exception of deposit insurance, the only currently meaningful reason for regulating financial institutions is to control the money supply and protect some suppliers of financial services from competition. Assuming that the last reason is not considered to be desirable and can be overcome politically, almost all restrictions on entry (including intra- and inter-state branching and the offering of all financial products), prices and the restructuring of organizations should be removed. With the exception noted below, financial intermediaries should be treated the same as other corporations.[1]

Consequently, almost all of the *raison d'être* of the federal regulatory agencies would be obviated. In particular the Office of the Comptroller of the Currency (OCC), The Federal Home Loan Bank Board (FHLBB) and the National Credit Union Administration (NCUA) would serve simply as chartering agencies for depository institutions. Because mutuals are not owned by investors who put their resources at risk, the FHLBB and the NCUA would have to act as the ultimate authority that could remove incompetent or dishonest managers. Stockholder-owned institutions, though, would be regulated no differently than other corporations. Charters would be granted to depository institutions if they had deposit insurance provided by an insurer that was approved by the OCC, the FHLBB or the NCUA. The existing deposit insurance agencies—the FDIC, FSLIC and FCUSIF—would be authorized to provide insurance to any depository institutions so that there would be some competition among insurors. (Therefore, it is important that they not be merged into a single agency as has been proposed). In addition, non-government insurers (such as major insurance companies) and banks could be recognized by the chartering agencies and could offer their services to the depository institutions. Because they bear the risk of failures, the insurers would impose whatever restrictions on the activities of the depository institutions that they felt useful, subject to the same sort of mutual agreement that insurance companies exercise with their other clients.

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[1] The principal regulators for banks would be the state banking commissions and the Securities Exchange Commission (Sec). For an analysis of the disclosure regulations of the SEC and proposals for reform, see my essay, "Security for Investors," in *Instead of Regulation: Alternatives to Federal Regulatory Agencies*, ed. Robert W. Poole, Jr., Lexington, MA: Lexington Books, D. C. Heath & Co., 1982, pp. 169-205.

The Federal Reserve Board would cease to have any responsibilities for bank supervision. The payments facilities would be divested and set up as a separate corporation with shares held privately. Reserves probably would continue to be required of depository institutions. And the Fed would lend reserves and provide currency at market rates that were consistent with its mandate to conduct monetary policy.[2] In the further interest of equity and efficiency, the taxes imposed on depository institutions would be the same as those imposed on other corporations. This would require the Fed paying interest on the required reserves and the Congress removing tax subsidies.

In short, it is time that we recognized that financial institutions are simply businesses with only a few special features that require regulation. The following analysis provides the reasoning and evidence on which this conclusion and the recommendations are based.

BASIC REASONS FOR REGULATING BANKING

Taxation

The Historical Record. Perhaps the oldest reason for regulating banking was to enhance the ability of those who had political power, be they monarchs or legislatures, to raise revenues (tax). Before the advent of central banking taxation took two forms: Seigniorage from the production of money and loans at lower than risk-adjusted market rates.

Seigniorage is the difference between the accepted and the commodity value of money. When the government could maintain a monopoly over the money supply, it could require people to use the designated money at its token value by declaring it to be legal tender. Since money costs considerably less to produce than its accepted or token value, the producer (the government) benefits. Even when people could substitute among other forms of money, the convenience over commodities (e.g., gold) of money that was backed by the power of the government to punish forgers enabled governments to obtain seigniorage from the production of money. However, because governments often abused their power to produce legal tender by debasing the currency and printing paper money with apparent abandon, people tended to prefer bank notes produced by private banks. Hence, governments tended to regulate banks for two reasons. One was to restrain the banks' interference with the government's gains from seigniorage. The second was to permit banks to produce money but tax them by requiring them to lend money to the government at favorable rates and/or to give an ownership share to those who controlled the government, e.g., the monarch and his associates.

Government regulation, therefore, took the form of restricting people from the money creation aspects of banking by requiring governmentally granted charters. Needless to say, relatively few charters were granted, since competition among money suppliers would reduce the profits from money creation, profits that could be garnered by government directly, through seigniorage, or indirectly, via loans from and ownership shares in the chartered banks that would be subsidized by the monopoly profits earned with the aid of regulations that restricted their competition.

Loans at less than market rates (net of an allowance for risk) were a favored means by which monarchs and other governmental officials taxed banks. (More accurately, the tax was imposed on the users of bank money, who were prevented from benefiting from competition among banks.) Unfortunately, but predictably, the governments tended to use this form of taxation for revenue to finance extravagances and wars, which led them to enhance further the possibility of the banks achieving monopoly profits that could be taxed additionally (fattening the calf). Sometimes the governments overdid it; loans were defaulted and banks failed (killing the golden goose). Thus a cause of major banking failures was overtaxation by government.

Central banking grew out of the use of banks as a source of governmental revenue.[3] As the bank that served as a revenue source for the government was given more complete monopoly powers and served as the government's primary source of loans, it became an instrument of government—the central bank (e.g., the Bank of

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[2] Alternatives to the present system are not considered herein.

[3] See Vera C. Smith, *The Rationale of Central Banking*, London: P. S. King & Son Ltd., 1936.

England). The existence of a central bank permitted the government to enhance its revenue from seigniorage since the notes of the bank tended to become the only legal tender (they were the only notes accepted in payment of taxes). Ocassionally this led to extreme excesses, as in the case of the monopoly given to John Law in 1716 for his Banque Generale, which issued notes with such abandon that the bank failed within five years, bringing the economy of France down with it. But most often, the central bank used its monopoly powers effectively, which included restraining excess production of notes and using the power of government to prohibit or control the issue of notes and deposit services by competitors.

Probably because of their experiences with the near-monopoly powers of the Bank of England,[4] the U.S. founding fathers generally were against the establishment of a central bank, whether privately or governmentally controlled. For this reason, together with the preeminence of states' rights and the desire of existing banks to avoid the dominance of a strong national bank, banking was regulated by the states until 1863, with the exception of the First and Second Banks of the United States, whose 20 year charters were not renewed when they expired. Prior to the National Currency Act of 1863 and National Banking Act 1864 (which established federal chartering), state chartered banks often were required to hold state bond issues as backing for their notes.[5] The national banks (the notes of which supplanted the state banks' notes when the National Banking Act of 1864 imposed a prohibitory tax on them) were required to keep U.S. obligations as collateral. While concern for the note holders was an important reason for this requirement, it also benefited the governments involved. State and federal reserve requirements on demand deposits similarly reflected the governments' interests.

The creation of the Federal Reserve in 1913 gave the United States its first central bank. By requiring member banks to hold reserves with the Federal Reserve or (since 1960) in vault cash, neither of which bears interest, the federal government imposed a tax on these banks and on their customers. When the reserve requirements were extended to all suppliers of third party transfers (checking accounts and equivalents) by the Depository Institutions Deregulation and Monetary Control Act of 1980, this tax was imposed generally (though still not evenly).[6] Since the Federal Reserve remits 90% of earnings on its investments in U.S. government obligations to the U.S. Treasury, in effect the tax is collected by the Treasury.

The Present Situation. Though regulation of and limitations on bank charters were instituted as a means of maximizing the amount of tax (direct and indirect) that could be imposed on banks and users of bank money, this type of regulation is no longer meaningful in the United States. Neither state nor federally chartered banks are required to invest in state or federal obligations or lend to the governments at favorable rates. But, by imposing reserve requirements on all providers of third party transfers, the Federal Reserve can and does impose a tax on users of bank money. Indeed, the amount of this tax and the efficiency with which it is collected is reduced by regulations other than reserve requirements that might be imposed on financial institutions. Limitations on charters or any other restrictions that impose costs on users of bank money reduce the value of this asset to users and, therefore, reduce the amount of tax that can be imposed. Therefore, assuming that a tax on users of bank money is desirable (an assumption that is questioned below), banking regulations other than reserve requirements on all money providers should be repealed.

Prevention of Centralized Power

The Historical Record. As noted above, the United States has a history of concern for and aversion toward centralized power. This concern was reflected in part by the refusal of Congress to renew the charter of the First Bank of the United States in 1811 and President Johnson's veto of the charter of the Second Bank of the United States in 1836. One argument against these banks was that they were too powerful (although many scholars believe that

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[4] The Bank of England did not have a complete monopoly. A few, smaller banks of issue were permitted to operate outside of London and entry was essentially unlimited in Scotland.

[5] See Hugh Rockoff, "The Free Banking Era, A Reexamination," *Journal of Money, Credit and Banking*, VI, May 1974, 141-167.

[6] For estimates of the tax imposed, George J. Benston, *Federal Reserve Membership: Consequences, Costs, Benefits and Alternatives*, A Study Prepared for the Trustees of the Banking Research Fund of the Association of Reserve City Bankers, Chicago 1978, Chapter III.

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the discipline imposed by the banks on their state chartered rivals was a more important reason for their demise.)[7]

The prohibitions against intrastate branch banking enacted by several of the states also may be considered to be a reflection of a basic bias against bigness. But the record does not support this as a general interpretation of branch banking legislation. While the branching activities of the Second Bank of the United States, in particular, were objected to by the state bankers with whom the Bank competed, by the end of the 19th century 20 states permitted branch banking. However, though the number of branches had increased somewhat from 1834 to 1900 (from 100 to 119), the increase in the number of banks over this period was so great (from 406 to 12,423) that the percentage of branches to banks declined from 24.5% to 0.0.[8] As the automobile increased mobility in the 1920s, branching increased steadily to 785 branches operated by 397 banks in 1915 to 3,005 branches operated by 724 banks in 1934.[9]

The increasing technological desirability of branching gave rise to two developments. One was the adoption of the McFadden-Pepper Act of 1927, which conceded to national banks limited power to branch in their home cities, subject to state legislation. (The home city restriction was removed in 1934.) The second was increased attempts by local bankers to have laws enacted that would restrain competition from larger banks. This often successful attempt linked branching with the underlying popular fear of centralized power. In this regard, an early observation by H. Parker Willis, the most influential U.S. banking academic of his time (or perhaps any time) is instructive and still pertinent. He states that the owners of small banks assert that branching "... would result in building up a money power which would crush the small banks out of existence. A more absurd reversal of the actual facts in the case could scarcely be imagined. What the establishment of branches would actually do would be to destroy the local money power which now practically stifles many forms of legitimate industry by a pressure of excessive interest rates, and by other even less justifiable means."[10]

Perhaps because the validity of Parker's remarks was recognized or possibly because the bankers in some states saw the advantages of branching, only a third of the states in the later 1920s prohibited banks from operating branches, a third permitted limited branching and a third allowed statewide branching. Presently, only 12 states prohibit branching, 15 allow limited branching and 23 statewide branching. Thus, a prohibition against branching neither was nor is the rule in the United States, and it is difficult to view the restrictions placed on this type of banking organization as a manifestation of a general fear of centralized power. Though the fact that interstate branching and nationwide banking has been prohibited argues in favor of the hypothesis that fear of large banks is a continuing feature of U.S. banking regulation, an alternative, or perhaps supplementary, explanation is that the restrictions have been based more on the local bankers' desire to protect themselves from competition. This is discussed below.

It also is important to distinguish the particular aspects of banking toward which the concern about centralized power was directed. Principally, centralization of the power to grant loans and make investments was the object of the founding fathers' fear. The centralization of note issuance also was important when bank notes were the most important circulating medium. Once demand deposit banking developed, there appeared to be relatively little concern about the centralization of this banking product. Nor was the centralized offering of collateral banking services ever considered much of an issue.

The Present Situation. Fear of centralized note issue is meaningful, but irrelevant for bank regulation; the Federal Reserve now controls or can control the money supply.[11]

Fear of the provision of centralized depository services has been stated as an important issue by bankers who oppose intra- and interstate branching. Without these restrictions they assert that large branch banks would come to dominate the country and local communities. In large measure, their concern is based on the assumption that there are considerable economies of scale in banking operations, such that banking is akin to a natural monopoly. However, empirical studies have not found this to be the situation. Earlier studies (using data from the 1960s) found some economies of scale with respect to operating costs (with output defined as the number of accounts processed and average dollar size of accounts), but higher costs of branching. These effects were offsetting for larger branch banks.[12] A recent study that uses nationwide data for 1975 through 1978 found diseconomies of scale and very similar average costs for branch and unit banks when all variables were held constant (including the average size of accounts), except the numbers of accounts and branches. Most importantly for the present question, a small unit bank had slightly lower operating costs than a similar branch of a branch bank, all other things held constant.[13] Therefore, there is no reason to believe that smaller unit banks and small banks generally have a cost-disadvantage, such that they could not compete with large banks. Consistent with this conclusion is the experience in New York State when statewide branching was permitted and several New York City banks opened offices in out-of-city locations. They were unable to take much business away from the existing banks.

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[7] See Deane Carson and Paul H. Cootner, "The Structure of Competition in Commercial Banking in the United States," Research Study Two in *Private Financial Institutions*, Prepared for the Commission on Money and Credit, Englewood Cliffs, N.J.: Prentice-Hall, 1963, pp. 56-59. They give three reasons for the limited lives of the two federally-chartered banks: 1) Concerns by agrarian and small business borrowers with concentrated banking power; 2) sentiment for unit banking (the U.S. banks were establishing branches); and 3) desire for inflation (the U.S. banks were conservative note issuers).

[8] Carson and Cootner, p. 65.

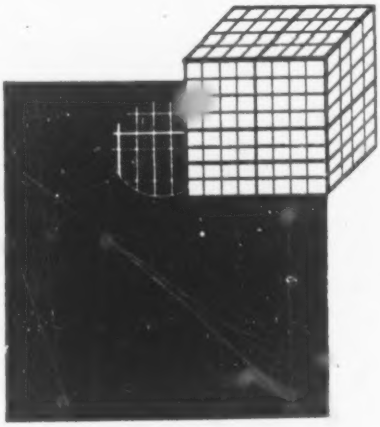
[9] Ibid, p. 73.

[10] H. Parker Willis, "The Demand for Centralized Banking," *Sound Currency*, Vol. 8 (March 1902), pp. 23-24.

[11] While there is reason to believe that this centralized power should be restrained, perhaps by repealing the legal tender laws and allowing alternative currencies and other means of payment to be used, the issue presently is moot.

Because banking does not appear to be subject to economies of scale, the removal of restrictions on entry can only serve to decrease the centralization of banking services, particularly in local communities that are served by few banks.[14]

Loans to large and to many middle-sized borrowers, at the present time, are made nationwide, indeed world-wide, by banks. Loans and other sources of capital, such as direct and publicly placed bonds and equity shares, also are available from a very large number of nonbanking services. Thus most business borrowers can look to commercial banks in all states and in other countries, to insurance companies, to pension funds, to venture capital companies and to underwriters for short and long-term capital.



Trade credit is another source of funds for businesses. Government agencies also supply loans. Consumers can borrow from and through commercial banks, thrift institutions, mortgage bankers, consumer finance companies, sales finance companies, life insurance companies and retailers, among others.

Since enactment of the "Garn-St. Germain Depository Institutions Act of 1982," which removed most of the restrictions in thrift institutions' lending to business, the principal constraint on peoples' opportunities for obtaining financing from banks is the Glass-Steagall Act provisions. These prohibit commercial banks from underwriting and dealing in corporate bonds and equity securities and from investing in equities. Similarly, underwriters are forbidden from offering depository services. Presently, this prohibition is supported by reference to fears of banks controlling loan and equity sources of funds. But were banks allowed to offer customers funds packaged as securities as well as loans, this would hardly result in a concentration of power, as long as the customers have the alternative of obtaining funds and services from insurance companies, pension funds, investment companies, underwriters and others. Another frequently expressed fear concerns the possibility of banks abusing their fiduciary responsibilities. In particular, they might use information gathered in the course of lending to trade in a corporation's equities. Or they might attempt to "bail out" of a bad loan by selling equities to the public, the proceeds of which would be used to repay the bank. If these fears were valid, though, they apply equally to underwriters, since they hold, buy and sell the corporate obligations. It also is important to note that though these fears presently are expressed, they were not given as argument for the Glass-Steagall Act. Rather, Senator Glass (who, prior to the bank failures that triggered the Act, had attempted to legally separate investment from commercial banking) believed as a matter of banking theory that the loans and investments of depository institutions should be limited to self-liquidity obligations (the real-bills doctrine.)

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[12] For a review of these studies, see George J. Benston, "Economies of Scale in Banking," *Journal of Money, Credit and Banking*, 4 (May 1972), pp. 312-341, and George J. Benston, Gerald A. Hanweck and David H. Humphrey, "Operating Costs in Commercial Banks," *Economic Review* (Federal Reserve Bank of Atlanta), November 1982.

[13] George J. Benston, Gerald Hanweck, and David H. Humphrey, "Scale Economies in Banking: A Restructuring and Reinterpretation," *Journal of Money, Credit and Banking*, XIV, (November 1982).

[14] Even if banking were characterized by economies of scale, consumers still would benefit by the removal of organizational constraints as long as entry were unrestricted. In this event, should a bank drive out its competitors by underpricing them, it could not subsequently raise its charges without inviting in new competitors or reviving the old ones. Considering that there are few physical, capital or technological barriers to entry, predatory pricing would seem to be a foolish practice, but one that is beneficial to consumers if it is practiced.

Restrictions on interstate banking and branching also limit, somewhat, the numbers of potential sources for loans for people living in less populated states and communities and in communities that straddle state borders. At the least, these restrictions tend to raise the price of loans to borrowers. Again, considering the multitude of sources for loans that are now available, there seems no reason to believe that any fear of centralized power can justify continuing these restrictions.

Avoidance of Competition

The Historical Record. Bankers are not unique in wanting to foreclose or limit competitors. As is discussed above, such limitations served the interests of monarchs and other governmental authorities and were the source of such regulations as restrictive chartering. In the United States, where, compared to Europe, many more banks were chartered, such restrictions on competition also took (and still take) the form of limiting or prohibiting branching. While these prohibitions often were (and still are) justified as a means of limiting centralized power, the reasoning and evidence given above is contrary to this rationale.

Limitations on the right of non-banks to offer banking services also were used to restrain competition. Until recently, thrift associations were prohibited from offering checking accounts to their customers. In most states they also were prohibited from offering consumer loans other than those related to real estate and a few types of specialty loans (such as education loans.) Nor could they offer checking accounts and loans to businesses. The prohibition against dealings with business were justified on the grounds of potential self-dealing by the officers of mutual associations and their charge to look to the needs of individual consumers. But these restrictions were maintained long after the thrift associations had changed from small, charitable institutions to large-scale lenders to real estate related enterprises as well as individuals.

Since banking was a regulated industry, the power of government also was used by the banks' competitors to constrain competition by banks (e.g., the Glass-Steagall Act which prohibits banks from offering securities underwriting services). Direct investments in companies not considered by the regulations to offer bank-like (congeneric) services also were prohibited. The argument for these constraints were couched in terms of concern for the safety and soundness of the banks or fear of centralized power by the banks. But the Glass-Steagall Act prohibitions were not based on empirical findings demonstrating that the provision of securities services by banks contributed to failures or to cheating of customers.[15] Rather, the evidence supports the belief that the investment bankers and underwriters were concerned about severe competition from banks and bank affiliates and sought (successfully in 1933) to eliminate these competitors.[16] Similarly, such businesses as travel agencies and computer service companies

[15] The most comprehensive work on the legislation lists the alleged abuses but does not cite any evidence of their occurrence. See W. Nelson Peach, *The Security Affiliates of National Banks*, Baltimore: The Johns Hopkins Press, 1941.

[16] Between 1927 and 1930, the participation of banks in bond issues grew from 36.8% to 61.2%. (Ibid., p. 110)

have sought to keep banks from providing services on the grounds that this would exceed the banks' legally granted powers. Thus regulation has worked both ways with respect to banks, though in either instance the cost was borne by customers.

The Present Situation. The desire and possibly the power of business people to restrain their competition is still with us. Commercial bankers do not want to face competition for business loans and deposits from thrift associations. Bankers who run small unit banks fear having to compete with the branch managers of large banks. Bankers in some states do not want to compete with bankers in neighboring or any other states. Brokers want to offer checking accounts but do not want bankers to offer brokerage services. And so forth.

But the ability of people in and at the periphery of the financial services industry to prevent others from competing for their customers is increasingly being eroded by technological change fueled by the opportunity cost of high nominal interest rates and the advantages of avoiding restrictive regulations. Three (of many) specific examples illustrate this situation:

- The transfer of funds by check first was offered by thrift institutions by means of negotiable orders of withdrawal and by credit unions with share drafts. Both forms of transfers look like checks, can be used as checks, but are legally not called checks. Better yet (for the consumer), interest is paid at the savings rate which, while constrained by Regulation Q, is still greater than the rate of zero permitted on regular demand deposits.
- Stock brokers offer their customers de facto checking accounts on which interest is paid at market rates. Furthermore, they are not constrained by geographic limitations, but operate nationwide. And they simultaneously can offer clients a wide range of investment alternatives, including direct ownership of stocks and bonds and participation in funds.
- Offices that solicit and service business and consumer loans are operated by major banks directly and as holding company affiliates in major cities throughout the country. Unregulated mortgage bankers and sales finance companies offer consumer loans throughout the country.

Thus the present set of regulations serve bankers who want to constrain competition primarily with respect to services provided on the local level, particularly deposit services where the depositor wants personally to deposit and withdraw funds. On the other hand, the regulations prevent bankers from organizing their operations in whatever way is most efficient for a given market and set of products and also prohibit them from directly offering a full range of services to their customers.

Bank Solvency and the Effects of Failures on the Economy

The Historical Record. Bank failures were not always considered to be horrendous occurrences to be avoided at all costs. All enterprises that involve risk may be sufficiently unsuccessful, poorly managed, fraudulently run or the victims of bad luck. Banks are no exception. And the record shows that banks regularly failed throughout history. Many of the more spectacular bank failures were due to overly rapacious taxation by monarchs and other government officials. In these cases, regulation served to increase the ability of the rulers to over-use their power to the detriment of the banks' other customers, owners and employees, and often of the state. While it is true that many banks failed because their operators acted incompetently or fraudulently, it appears that failures were more often the consequence of governmental interference or incompetence.

The experience of the United States, which (together with Scotland) was one of the few countries that permitted competitive banking, is particularly instructive.[17] Prior to 1837, bank charters had to be obtained by special acts of the state legislatures. In part to avoid the corruption that tended to accompany the granting of these quasi-monopolies, and in part because of the public demand for more banking facilities and a sentiment toward unrestricted enterprise, Michigan in 1837 and New York and Georgia in 1838 enacted free bank chartering laws. These laws permitted anyone to open a bank who provided a minimum amount of capital and deposited with a state agent a specified amount of bonds that could be sold to repay the holders of bank notes (which served as hand-to-hand cur-

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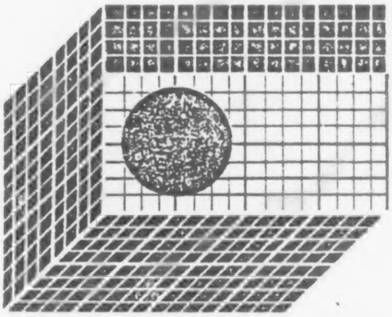
[17] The Scottish experience is one of stable banking, much more so than the experience of England with its central bank and restrictions on entry and competition.



rency) should the bank fail to redeem the notes as promised. By 1860, 18 of the 32 states had passed such laws (Michigan twice.)[18]

Because some of the state laws were drawn so as to permit the bankers to issue notes with face values in excess of the market values of the bonds, and because the public was led to believe that the bonds provided adequate security for the notes, "wildcat" banking was profitable in some of the states. Wildcat banking occurs when bankers issue many more notes than they can redeem and, if the notes stay in circulation long enough (whence the term, wildcat banking, which refers to establishing redemption offices in areas populated primarily by wildcats), the issuers can profit even if they later become bankrupt. In these states, there were many bank failures. Michigan, in particular suffered such a rash of failures (the typical life span of a free bank was no more than six months) that the legislature suspended the law after about a year, in April 1838. The reason for this bad experience was that the notes issued by the Michigan banks did not have to be redeemed in specie and could be backed by mortgages. Consequently, Rockoff explains, people would "create a mortgage on a worthless piece of property, have it certified as being valuable by some friends, and then transfer it to a wildcat bank in exchange for a mass of bank notes. . . . Other [currency issues] were simply frauds which operated in violation of the free banking law."[19]

Nevertheless, the losses suffered by the public as a consequence of holding worthless or depreciated bank notes were not great. Including the $1 million lost by holders of Michigan bank notes and $394,700 lost in the first years of New York free banking (after which losses were negligible), estimated losses in the 18 states through 1860 totaled only $1,852,900, or less than 2% of the money stock.[20] Indeed, despite its bad experience, Michigan reinstated free banking in 1857. On the other side of the ledger, free banking resulted in increased banking services and lower profits to banks (and, hence, lower costs to consumers). Furthermore, private regulatory arrangements, such as the Suffolk system in Boston and the New York clearinghouse, virtually eliminated the member banks' failures to redeem their notes for specie.

The national banking system, created in 1863, represented a continuation of free banking, since entrepreneurs were able to obtain bank charters without having to get special bills passed by state legislatures. However, they did have to put up more capital than was generally required for state charters, maintain specified reserves against their deposits, and could issue bank notes only in amounts that did not exceed the lesser of 90% of the market value or 100% of the par value of registered U.S. bonds which had to be deposited with the U.S. Treasurer. Even then there were many bank failures for reasons which included actions by the U.S. Treasury that reduced the amount of bonds available for backing note issues, and a prohibition of branch banking that was not relaxed somewhat until 1927.

Even after 1927 (indeed to this day) banks are restricted from branching within many states and across state lines by state-enacted laws. These laws restrain banks from efficiently diversifying their operations geographically. Hence, they are more liable to local and area economic failures and depressions. This is borne out by the data, which show that from 1921 through 1931, when 8,916 banks were suspended, only seven were banks with more than ten branches; of these, only three operated branches outside the city of the head office.[21] It should be noted, however, that permission to branch intra-state is unlikely to have benefited most of the banks that failed. As is described further below, the largest group of failures were among small banks in agricultural states. But, had interstate branching been permitted, these banks could have diversified sufficiently, as did the Canadian banks, where nationwide banking was permitted and only one bank (in 1923) failed.

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[18] See Rockoff, op. cit., from which this account is drawn.

[19] Ibid., p. 146.

[20] Ibid., pp. 150-151.

George J. Benston, "Bank Examination," *The Bulletin* of the Institute of Finance, Graduate School of Business Administration, New York University, Numbers 89-90, May 1973, Table II p. 12.

The data on bank suspensions since about the turn of the century might, by contemporary standards, appear descriptive of a total banking collapse. Between 1890 and 1899, 1084 banks were suspended, 1789 were suspended between 1900 and 1920, and 5712 between 1921 and 1929.[22] Expressed as annual percentages of active banks, the suspensions in each of the periods are 1.50%, .34% and 2.30%. As annual percentages of the deposits of active banks the deposits of the suspended banks are .10% for the 1900-1920 period and .42% for the 1921-1929 period. And in the period of the largest number of suspensions, 1921-1929, the average annual losses borne by depositors as a percentage of deposits are only .15%. Thus, in the decade before the debacle of the Great Depression, the losses to depositors were not very great. Perhaps this is the reason that, despite the large number of suspensions, there were no successful moves to "reform" the system. Nor did the bank suspensions adversely affect the economy in general. In fact the overall growth of the economy was particularly great in the 1920s, the period of the greatest number of suspensions. To the contrary, the principal cause of the suspensions appears to have been adverse local economic conditions, particularly those in the agricultural regions of the western grain states (where 47% of the suspensions during 1921-1929 occurred) and of the southeastern and southwestern states (with 18% and 11% of the suspensions).

The Great Depression saw 9096 bank suspensions between 1930 and 1933. These are 11.29% per year of the active banks; they held 4.14% of the deposits. Between 1930 and 1933 the average annual losses borne by depositors as a percentage of deposits averaged .81%, 5.4 times the loss rate of .15% experienced in the 1920s. While the great number of bank failures undoubtedly affected the economy negatively, most scholars agree that the banks were primarily the victims rather than the cause of the Great Depression.[23]

However, it should be noted that bank runs played an important role in the Great Depression and in previous financial collapses. "Black Thursday" 1873 saw the failure of Jay Cooke's banking house and the first closing of the New York Stock Exchange. It was followed (perhaps causally) by six years of depression. The failure in 1884 of former President Grant's firm, Grant & Ward, and of the Marine National Bank sparked runs and the consequent failure of numerous banks and brokerage houses. The Panic of 1893 was touched off by the 1890 failure of the London banking firm of Baring Brothers, which specialized in financing U.S. enterprises. Baring's European creditors demanded that American pay their debts in gold. As a consequence, the base money supply was depleted and a multiple contraction resulted, and 1891 saw a mini-panic. During the following 1893 panic over 600 banks and 13 of every 1,000 businesses failed in perhaps the second deepest depression (after the depression of 1837) in the nation's history before 1930. The New York Clearing House suspended convertibility to specie, which ended the run. The situation also was helped by J. P. Morgan's negotiation of a sale in Europe of a $100 million U.S. bond issue. Panic struck again in 1907 when New York City and several corporations were unable to sell high yielding bond issues. The Knickerbocker Trust Company failed (largely as a consequence of speculation with depositors' funds) and several major banks experienced severe runs. Again, the New York Clearing House suspended convertibility to specie and J. P. Morgan later helped increase reserves with European loans and U.S. Treasury deposits.

The creation of the Federal Reserve in 1913 was supposed to rid the country of these recurring collapses. As the lender of last resort, with great resources and the power of the printing press, it should have been able to better the

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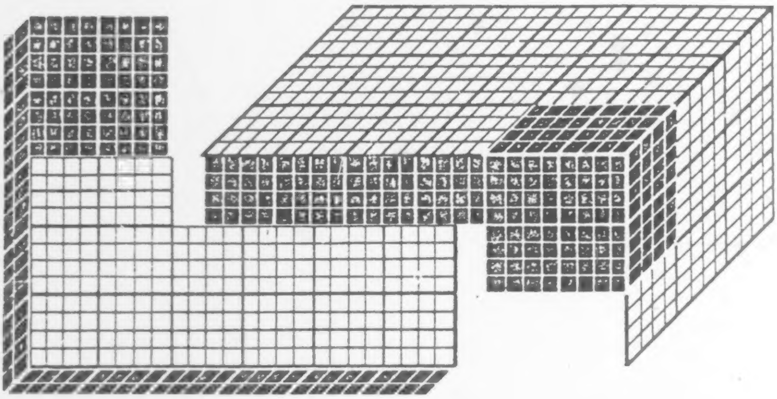
[22] Ibid., Table II, p. 12.

[23] Clark Warburton carefully studied the relationship between bank failures by county and the 1930s depression. He conlcudes: "There was a massive contraction of deposits nationally, during the early 1930s, relative to the rate of growth during the 1920s, of which less than one-fourth was accounted for by deposits in suspended banks. This indicated that the depression of the 1930s could not be explained by the impact of balances of payment resulting from adverse conditions in particular industries or areas, but was due to, or at least associated with, some potent force operating on a national scale." (*Depression, Inflation and Monetary Policy, Selected Papers; 1945-1953*, The Johns Hopkins Press, Baltimore, MD: 1966, p. 2).

FEDERAL REGULATION



New York Clearing House's and J. P. Morgan's record. But, when the Bank of the United States collapsed in 1930, runs were made on other banks. And the Fed did not prevent the collapse of a third of the banks during the next several years. Though the losses to depositors and others as a consequence of the panics that preceded the Federal Reserve were considerable, the costs absorbed by the public after the creation of the central bank appear to be greater. The sharp and relatively short depressions of 1837, 1873, 1893 and 1907 should be compared with the Great Depression of the 1930s. The recession of 1920-21 should be contrasted with the sharper recession of 1937-38 (when the Fed doubled the required reserves ratios) and the relatively small post World War II recessions, and the present recession. And the cost of losses in purchasing power absorbed by depositors because of the non-war time inflations of 1916-17 and the 1970s to the present should be compared to the losses depositors took because of bank failures at all times, including the 1930s. The record may not give one faith in regulation by a central bank as a means of protecting depositors and maintaining the solvency of the banking system and the economic well-being of the nation.

The creation of the Federal Deposit Insurance Corporation in 1933 was a salutatory innovation. Since most depositors no longer need fear that their funds will be lost should a bank fail, runs have largely become a relic of the past. The word "largely" is used because uninsured depositors (those with over $100,000 in an account) have reason to fear loss of their funds, particularly if the FDIC closes the bank rather than arranges for its assumption by another bank. Furthermore, the event of a bank failure gives large depositors reason to question the safety of their funds in other banks where the assets held and operating procedures appear to be similar to those of the failed bank. For example, when the Penn Square and Abilene National banks failed in 1982, other banks faced the problem of convincing depositors that their funds were safe. However, the snowballing effect of pre-FDIC runs did not occur. Nor did banks that were unconnected to the failed banks experience difficulties.[24]

The question to be considered, then, is whether bank failures or even the possibility of limited bank runs are presently a matter for concern more than the failure of any nonregulated enterprise.

The Present Situation. With the possibility of a bank failure causing runs on other banks largely a concern of the past, and with protection of bank note holders no longer meaningful since the currency is provided and guaranteed by the Federal Reserve, what reasons can be adduced for governmental concern about the solvency of banks? This question can be answered by considering the costs to the principal persons who would be affected by a bank failure: Owners, employees, borrowers, depositors and users of other banking services.

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[24] An exception is the small run on the Franklin Savings Bank when the Franklin National Bank (an unrelated institution) failed.

The owners (stock and bondholders) clearly are hurt by failures. But their position is no different than that of the owners of other enterprises. In fact, because banks use little if any specialized assets, the owners tend to lose less than had they owned the shares of most other types of businesses. Mutual banking organizations—mutual savings banks, savings and loan associations and credit unions—are an important exception. The mutual form was adopted for these institutions because they began as charitable or fraternal, non-profit organizations. Most of them are constrained by competition in the market place to operate as efficiently as do stockholder-owned institutions. But, unlike the situation for stockholder-owned enterprises, monitoring by stockholders and the securities market is not present. Consequently, should a mutual institution be operated inefficiently or fraudulently, there is a need for a supervisory government agency to step in to protect the equity in the assets that, in effect, belong to the community.

Employees of banks also would be adversely affected by the failure of their employers. But, because so many banks operate similarly, bank employees have skills that are readily transferable, unlike the employees of most other enterprises. In addition, a failed bank is likely to be absorbed into another bank rather than dissolved. Hence bank employees are less in need of governmental concern than are other workers.

Borrowers would lose the value of their contacts with the officers of a failed bank and the officers' knowledge of them. But if the failed bank is taken over by another organization, the cost is likely to be small. Depositors whose accounts are fully insured suffer, at most, a short delay and some inconvenience until their accounts are paid off or transferred to another bank. Uninsured depositors might lose. But since they are holders of large accounts (currently over $100,000), it seems likely that they are capable of assessing the risks and obtaining sufficient compensation, *ex ante*, for the risks. In any event, the historical record suggests that the expected losses are relatively small. Nor are the users of other bank services likely to be seriously inconvenienced, since if entry were not restrained by regulation, there are likely to be many competing sources of services available.

This leaves only the owners and others associated with banks that might experience runs because an apparently similar bank failed. To the extent that these banks are misperceived as offering greater risks to uninsured depositors, they will bear unfairly imposed costs. But the possibility of runs also gives banks a salutary incentive to conduct their affairs such as to engender confidence among their large depositors. The complete removal of this concern by depositors and of the banks about depositors' fears is likely to lead to greater than optimal risk-taking by banks. In the following section, some changes in the present institutional arrangements are suggested that should lead to a better balance between these conflicting concerns.

To summarize, in today's environment with FDIC insurance, the effect of a failure of a bank on employees and customers (and hence on communities) and even on owners is likely to be less than for most other types of enterprises. With bank runs virtually not a problem, the possibility of failure is no longer a valid reason to subject banks to special regulations other than deposit insurance requirements. (The interests of the deposit insurance agency and of the banks with respect to deposit insurance are considered next.) Indeed, there is reason to believe that many of the regulations imposed on banking increase the possibility of failure. In particular, regulations restricting branching reduce the banks' ability to diversify their deposits geographically. Restrictions on the types and maturities of the products that they can offer their customers similarly restrict their ability to diversify their portfolios. (Witness the current situation of thrift institutions because of past regulations.) Hence, they are more vulnerable to unexpected changes in local economies, the fortunes of specific industries (e.g., housing), and interest rates. The regulations also reduce the alternatives available to customers should a bank fail. Therefore, if concern for bank failures is an important issue, these restrictive regulations should be removed. The only supervising function that might be justified from a concern with failures is the ultimate supervision of mutual institutions.

Deposit Insurance

The Historical Record. Federal deposit insurance, established 1933, came about as a consequence of the very large number of bank failures of the early 1930s. These were primarily the consequence of the joint effect of a major sustained decline in the money supply and the U.S.'s fractionalized banking system, where inter-state branching was not allowed and many states prohibited or restricted branching.[25] Consequently, the portfolios of a large number of banks were not diversified geographically or across many types of businesses. Hence, they were inordinately subject to the effects of local economic collapses and to a rapid decline in the money supply. The banks in other countries did not suffer similar failures because they were able to meet deposit drains with funds drawn from other areas. While the U.S. banks had established relationships with other banks from whom, presumably, they could borrow funds, these express or implied contracts apparently did not hold up in the generally adverse conditions of the early 1930s.[26]

Following the collapse between 1930 and 1933 of 9,096 commercial banks (36.4% of those operating in 1929), 526 savings and loan associations (4.4% of the total in 1930), and 10 mutual savings banks (1.7% of the number in 1930), some reform was politically, if not economically, necessary. The smaller unit banks opposed branch banking and, considering that in 1930-31 93% of the suspended banks had total loans and investments of under $2,000,000 (70% were under $500,000), they reasonably feared both gradually lost deposits and runs as depositors sought the safety of larger banks. The large banks wanted to eliminate the payment of interest on demand deposits, since they had been unable to sustain repeated agreements to limit competition among themselves for the deposits of correspondent banks and large non-bank depositors.[27] The apparently politically acceptable compromise was a liberalization of the branch-limiting McFadden Act to permit national banks to branch to the extent that state banks could branch (but not permission to branch regardless of state law either within states or nationally), the legal prohibition of interest payments on demand deposits, and the establishment of the Federal Deposit Insurance Corporation. Although the FDIC insured individual deposit accounts only to a maximum of $2,500 (raised the next year to $5,000), assessments were imposed on a bank's total deposits. Thus the larger banks, that held largely uninsured deposit accounts, subsidized the small banks. But as Carter Golembe estimated, this cost was almost exactly offset by their savings of interest payments on demand deposits.[28]

Federal deposit insurance not only has benefited smaller and particularly unit banks, it has made bank runs no longer a serious problem. Banks are unlike all other enterprises in being subject to the externality of runs. For example, if someone is a bondholder of General Motors Corp. and believes that the company has or is about to absorb large losses, the best that person can do is sell the bond to someone else before the buyer learns of the bad news. The bondholder cannot successfully get General Motors to repay the bond until it is legally due. But if someone is a demand depositor in a bank and believes that the bank is in financial difficulties, funds can be removed by the person simply by writing a check or personally making a withdrawal. Since a rapid withdrawal of funds by depositors may force the bank to sell assets at distress prices or borrow at high rates, this may result in losses that exceed the stockholders' investment, losses that will have to be absorbed by the remaining depositors. Therefore, even if the bank is paying depositors interest that compensates them for the risk they take, the depositors are well-advised to remove their funds if the probability of a failure times the deposit balance exceeds the cost of making another banking arrangement plus any interest that might be foregone if it were credited on a delayed basis. With deposit insurance, those depositors whose balances do not exceed the insured amount need not fear a bank failure. While depositors with uninsured balances face potential losses should the bank fail, they need not fear a panic by the presumably uninformed holders of smaller accounts. Furthermore, depositors' experience with the FDIC gives them reason to believe that the deposit liabilities of most banks (especially very large ones) will be assumed by other banks without loss to the depositors. Hence, while they are not completely shielded from loss, the risk is very small and the incentive for panic withdrawals is concomitantly small.

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[25] Note Warburton's study referenced above, the concentration of suspensions among small banks (noted below), particularly those in the agricultural areas, and the very few failures of branch banks noted above.

[26] The only important exception is the mutual savings banks. Apparently because of a fraternity derived from shared mutualism, they provided each other with the currency needed to pay off anxious depositors and, then, stem incipient runs. They also benefited from not practicing reserve banking and from their concentration in long-maturity assets, the present values of which increased when interest rates declined unexpectedly.

[27] See Carter Golembe, "Memorandum re: Interest on Demand Deposits," Carter H. Golembe Associates, Inc., Volume 1975-10 for an excellent review of the legislative maneuvering.

[28] Ibid., p. 7.

But because federal deposit insurance saves insured depositors (and, to a large extent, uninsured depositors, as well) the cost of learning about the operation of banks, it also serves to free the banks from the discipline of those depositors' concerns. In this situation, the banker has an incentive to put the depositors' funds into risky assets. Should the events turn out well, the banks' stockholders reap the benefits. Should events turn out badly, the FDIC pays off the depositors. While the stockholders also are likely to lose their investments, in the absence of a sufficient risk premium or other costs imposed by the FDIC, the expected gains from risk-taking exceed the expected losses.[29]

Previous (prior to the FDIC) U.S. history bears out this expectation and also provides lessons that should be useful today. Prior to the National Banking Act of 1863, deposit guarantee systems were established in New York (1828), Vermont (1831), Indiana (1834), Ohio (1845) and Iowa (1858).[30] The New York and Vermont systems were state run and the others were based on mutual agreements among the participating banks. Their systems operated successfully, largely because they included the authority of the plan officials to monitor operations of the participating banks and control excessive risk-taking.[31] A second wave of deposit guarantee plans for state banks occurred after 1908. With one exception (Mississippi), the plans did not include effective supervision and they failed. These included the compulsory plans of Oklahoma (1908), Nebraska (1909) and South Dakota (1916) and the voluntary plans of Kansas (1909), Texas (1910) and Washington (1917). Since depositors were told that their money was safe, there was a great incentive for unscrupulous operators to take excessive risks. Indeed, the record shows greater failure rates of guaranteed banks than among similar nonguaranteed banks operating in the same areas. The Mississippi plan (1915), which included supervision and bank examinations, continued until 1930.

Thus a cost of deposit guarantee represents effective supervision by the insurance company or other authorities and/or the charging of risk-adjusted rates. While fees that reflect the risk could be charged by the FDIC, Federal Savings and Loan Insurance Corporation (FSLIC) and National Credit Union Share Insurance Fund (NCUSIF), they have opted instead to impose costs in the form of on-site examinations on the insured institutions. When the operations of the institutions are considered to be unsafe, the institutions are subjected to more frequent and more extensive examinations. The cost of these examinations include per diem fees (levied by some agencies) and the cost of disruption. Restrictions on the institution's right to expand and required infusions of capital also are imposed. More severe penalties include cease and desist orders, the removal of the institution's officers and its closing or merger with another institution. The extent to which these costs exceed the benefits from deposit guarantees and alternatives to the present system are considered next.

The Present Situation. Given the past history of bank runs together with the fractionalized banking system that makes stopping runs difficult, it appears to be necessary to continue deposit insurance. It is possible that the necessity for mandatory deposit insurance would be obviated if the Federal Reserve could be counted on to provide the reserves required to offset runs and if the removal of regulations made it possible for banks to offer depositors an acceptable mix of interest payments, diversified portfolios and private insurance. But considering the almost universal expectation by depositors with smaller account balances that they need not acquire information about the riskiness and management of bank assets, continuation of deposit insurance appears to be unavoidable. Also, considering the cost to these borrowers of assessing risks, an insurance system would seem to be cost effective.

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[29] If entry into banking is not constrained (as is suggested in this paper), the gains to shareholders from risk-taking will be greater, *cet. par.*, since they will no longer face the loss of rent from restricted entry.

[30] This narrative is derived from George J. Benston "Bank Examination," *The Bulletin*, Institute of Finance, Graduate School of Business Administration, New York University, Nos. 89-99, May 1973, pp. 50-52.

[31] However, it should be noted that the New York state system was phased out as bank charters were granted and renewed under the free (entry) banking law. As banks left the insurance system, the premiums went up considerably.

The present system though suffers from three important defects. One is that the procedure of charging depository institutions a flat-fee against their total deposit liabilities gives the institutions an incentive to hold riskier assets. At the same time, the insurance agencies (FDIC, FSLIC and NCUSIF) have a complementary incentive to over-regulate the institutions, since the agencies lose should a failure occur but do not garner the gains from a risk taken. There is no reason to believe that the outcome is reasonably close to optimal, particularly with the respect to the efficient allocation of capital. Second, bank runs still can be a problem, since uninsured depositors have a considerable incentive to remove their funds if they believe a bank will fail and not be assumed. Probably because of this expectation, very large banks (which hold relatively large amounts of uninsured deposits) have been loaned large sums of money by the Federal Reserve to keep them from failing and, when they failed, assumptions rather than payments were arranged by the FDIC. Consequently, depositors in such banks are, de facto, 100% insured and they no longer serve as monitors of the banks' activities. Collaterally, banks that are thought to be subjected to the payout procedure are placed at a competitive disadvantage. Third, the methods of examination and supervision employed by the agencies are unlikely to be efficient, since each is in a monopoly position with respect to its institutions; e.g., national banks cannot elect to be examined by the FDIC rather than by the Comptroller of the Currency. Although the agencies have made some attempts to improve their supervisory methods in recent years, Flannery and Guttentag (among others) find the techniques used to "fall well short of the state of art."[32] As long as the agencies have a clientel that has no alternatives, they need not be too concerned with the costs of inefficient examinations and over-supervision.

The flat fee compared to variable-risk-fee defect could be corrected by requiring the insurance agencies to charge risk-related fees. One might ask, though, why they have failed to adopt this procedure, even though it has been suggested by most writers on the subject and is used by most private companies. The answers might be that the assessment of banking risk is too difficult, would engage the agencies in too great an involvement in banking activities (since risk-related fees have the effect of directing a banks' allocation of resources), or that there presently is no incentive for the agencies to change established procedures. While there is some validity in each explanation, I prefer the last, which implies that unless the present legal arrangements are altered, the flat-fee system will remain.

The remaining possibility of bank runs could be eliminated and the monitoring by depositors enhanced by the following change. All deposits transferable on demand (including savings deposits for which the 30 day waiting period is almost never invoked) would be completely insured. But all time deposits over, say, $10,000, would not be insured at all unless a bank wished to purchase the insurance. Under this regime, runs could not occur because the time deposits could not be withdrawn until maturity. But, if a bank was thought to be operated in a manner that might result in a failure, the expectation would be reflected in the interest rates it would have to offer on its time deposits and certificates.

Finally, the defects of inefficient examination and supervision and the charging of inappropriate insurance fees can be cured, or at least reduced, by introducing competition among insurers for the business of financial institutions. Competition can be introduced first by permitting any depository institution to be insured by any of the three federal agencies. The agencies would be permitted to levy the types (e.g., variable rates) and levels of charges and monitoring mechanisms (e.g., examinations) that they felt desirable and the institutions could switch among the agencies much as any person can choose insurance companies. Then, to introduce even more competition into the market for deposit insurance, depository institutions should be permitted to purchase insurance from private companies or from other banks, as long as these companies and banks were approved by the chartering agency (about which more is said below). The private insurance can be in place of or supplementary to government agency insurance. So that the public is not misinformed, the depository institutions would have to prominently state the insurer they use, much as they now must state "Member Federal Deposit Insurance Corporation."

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[32] Mark J. Flannery and Jack M. Guttentag, "Problem Banks: Examination, Identification and Supervision," in *State and Federal Regulation of Commercial Banks*, Leonard Lapidus and Others, Federal Deposit Insurance Corporation, 1980, Vol. II, p. 218.

One should consider the concern that competition among insurers might lead to "agency shopping" by badly or fraudulently run banks wanting to escape regulation. Two factors argue against this possibility. One is the evidence of switches in bank charters. During the years 1960 to 1966, when Comptroller of the Currency James Saxon liberalized regulations, state banks had an incentive to convert to national charters. In the years since the late 1960s, when the opportunity cost of required reserves increased considerably, banks had an incentive to switch to non-member bank status. But the number of state banks adopting National charters from 1960 through 1977 relative to the number at year end 1977 was only 5.9%. In the same 18 year period, 6.3% of the national banks became nonmembers.[33] A detailed study of these (and other) changes revealed that "some, but not many, bankers abuse the forum shopping principle of choice."[34] The second, more important factor, is that a depository institution cannot change to another insurer unless that insurer accepts the institution. Since the insurer bears the cost of a failure, it has a strong incentive to refuse to accept institutions that are badly or fraudulently run.

Control of the Money Supply

Even those economists who do not declare that control of the supply of money is essential believe it to be desirable. The Federal Reserve can effect this control in several ways. As is the procedure in many countries, the central bank could issue and withdraw legal tender by buying and selling securities (open market operations) and by printing currency. The demand deposits (which hereafter includes such close substitutes as NOW accounts) portion of the money supply then could be controlled via the substitution by money users of currency for deposits and vice versa. The principal problems with this procedure are that demand deposits comprise the bulk of the money supply, the link between deposits and currency is inexact, and there are real resource costs in not permitting the public to have the amount of currency required for day-to-day transactions. Most of these problems can be avoided by using required reserves against demand deposits to control the money supply. The central bank can determine the amount of reserves that banks (hereafter denoting all suppliers of demand deposits) hold with one or a combination of three methods: Adjusting the required reserve ratio, open market operations and/or controlling borrowing from the central bank. Changes in reserves that result from changes in float, foreign transactions, Treasury operations, shifts among deposits against which different reserve ratios are required (if this practice is followed), and changes in the banks' and the public's desired holdings of excess reserves and currency can be offset with open market operations.

For the effective control of the money supply via reserves, the central bank must have information on the banks' reserve balances and be reasonably assured that the relationship between the reserves and the money supply is stable or, at least, predictable; e.g., there will not be unexpected shifts of deposits for money substitutes that it cannot effectively offset. For this purpose it is desirable (but not necessary) that the providers of demand deposits be subject to specified reserve requirements and that they be known to and possibly report to the Federal Reserve. (Reporting would not be necessary if the Fed could adequately estimate the needed data with sampling.)

Monetary policy would be more effective if velocity were more predictable. For this reason, and as an aid to identifying the assets that are used by the public as money, it would be desirable if the opportunity value to non-banks of providing money substitutes were minimized. For these purposes (and for reasons of equity and the efficient allocation of resources), bank-provided money should not be taxed at a higher rate than other forms of money. This leads to the conclusion that the Federal Reserve should pay interest on the required reserves it holds against demand deposits. The rate of interest should offset the opportunity loss to the banks of the funds required to be held as reserves. With no other regulations imposed on banks (other than required deposit insurance) competition would ensure that the demand depositors rather than the banks would benefit from the removal of this tax on their funds. While the govenment would lose this source of revenue, the public would gain from the Federal Reserve's more effective control of the money supply and from a more efficient allocation of resources. At the same time, tax subsidies to banks should be removed, such as their right to earn tax free interest on state and municipal bonds while being allowed to deduct against taxable income the cost of funds used to purchase the bonds.

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[33] Randall J. Miller, "An Analysis of Chartering and Conversions, 1960-1977," in *State and Federal Regulation of Commercial Banking*, Leonard Lapidus and others, Federal Deposit Insurance Corporation, Washington, D.C.: 1980, Volume II, pp. 495-496.

[34] Ibid., p. 492.

The Furtherance of Social Goals—The Provision of Banking Services

Three general types of social goals are distinguished: 1) The provision of the banking services of loans, fund transfers and savings; 2) support of housing and other attempts to allocate credit; and 3) prevention of individual discrimination and unfair dealing against individuals. Each is described and analyzed individually in the following sections.

The Historical Record. Until recently, commercial banks were expected to further social welfare primarily by providing businesses and consumers with an efficient means of making transactions (bank notes and checking) and borrowing and lending assets (loans and savings). The banks also served as a vehicle for collecting taxes (as is discussed above). The additional goal of unrestricted access to these facilities was characteristic of the United States. Hence a powerful, national quasi-monopoly bank, such as the Bank of England, was not permitted to develop until the Federal Reserve was created in 1913; and, for most of the nation's history, bank charters were not difficult to obtain.

It is important to note that the Federal Reserve was not conceived of as a central bank, but as a bank for and by bankers. Its function was to facilitate check clearing and provide other banking services for its members. After it was converted into a central bank by Senator Glass and President Wilson, a principal social purpose still was the development of an efficient nationwide clearing system as well as a vehicle for eliminating panics and providing the nation with an "elastic" currency. The cost of the system was borne by the members with the non-interest bearing reserves they were required to keep at the Federal Reserve Banks. With the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, the Fed was directed to charge users of its services for the full cost of those services. By this action, the social desirability of publicly supporting a national payments system was recognized as being no longer a concern of the present.

The United States developed specialized financial institutions in large measure to serve perceived social goals. Mutual savings banks (MSBs) were established (the first in 1816) for the social purpose of providing a place where the working poor could save with safety.[25] These institutions were founded as mutuals because the costs of providing these services exceeded the revenues derived therefrom; hence space and personal services often were donated and the institutions were not taxed. The MSBs were established primarily in the northeast, where they dominated the market for savings. They did not develop much in other areas of the country, for two reasons. One is that the mutual form of organization made establishment of a new bank difficult, particularly when the charitable desire to help the poor in this way was not as strong as it was in the northeast. The second is the newly-established banks in the other, newer states were not averse to serving the less affluent individuals shunned by the well-established northeastern banks. Because their principal stated goal was service to the working poor, and as a consequence of some failures during the panic of 1873, the MSBs were legally prohibited from investing these peoples' savings in such risky and potentially fraudulent assets as business loans. Consequently, they tended to hold bonds. By 1910, though, about half of their portfolios were in mortgages. The percentage declined after the 1930s and did not get up to about 60% to 70% until the 1960s.

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[25] See George J. Benston, "Savings Banking and the Public Interest," *The Journal of Money, Credit and Banking*, IV Part II (February 1972), Chapter II.

Savings and Loan Associations (S&Ls) were established principally to make mortgage loans. They developed from mutual building and loan societies. In the early years of the Great Depression federal chartering of mutual S&Ls was established with the goal of helping the housing industry recover. Thus, although the financial statements of the S&Ls and MSBs now look very similar, they were initially established to serve different social goals.

Consumer finance companies and credit unions also were established for a social purpose. Consumer finance companies were licensed by states (the first in 1916) to make small loans at gross rates that greatly exceeded the states' usury ceilings. The small loan laws were passed when it became clear that the urban population was prevented by the usury statutes from obtaining loans legally; those who were unable to borrow from friends and relatives had to turn to loan sharks. Credit unions similarly were established to provide a source of small loans to individuals. Churches, fraternal groups and businesses supported their development with donations of space and labor, since they made loans to members of these groups. Their growth also was helped by exemption from taxation.

The Present Situation. The laws and regulations that first forbade and now constrain thrift associations from serving their clients have had a negative social impact. As consumers' demands changed from wanting a safe haven for savings and for mortgage loans to also wanting a wide range of financial services (particularly checking accounts and consumer loans), the institutions should have been free to offer the products demanded. Furthermore, the institutions were prevented from offering business loans and other services that would have benefited their communities. Similarly, restraints on commercial banks (e.g., the Glass-Steagall Act) that prevent them from offering a full range of services and geographical constraints in the form of prohibitions against intra- and inter-state branching have kept them from meeting the social goal of service to consumers. Laws that limit payments to savers—the prohibition of interest on demand deposits and Regulation Q—obviously are contrary to the social goal of not hurting consumers, particularly since these limitations affect mostly the depositors who are ignorant of such alternatives as money market funds or who hold balances that do not meet the funds' minimum requirements. Indeed, it is difficult to find any of the laws and regulations that prohibit or constrain banks or any enterprises from offering their services to the public as operating to further social goals as these usually are expressed. While these constraints may have been imposed to reduce the incidence of bank failure (although that motivation and the effectiveness of the laws and regulations for that purpose are very doubtful in many instances), the advent of deposit guarantees should have eliminated this concern.

The continued provision of payments clearance and other banking services by the Federal Reserve also is no longer relevant for advancing the social concern of improved banking services. Alternative and supplementary services have been offered by non-government organizations for some time. Now that all depository institutions that offer third-party transfers are required to maintain reserves with the Federal Reserve Banks and all can obtain Federal Reserve services at a price, there seems no reason for these services to be provided by a government agency. Rather, this aspect of the Federal Reserves' operations should be split off into a separate corporation. A method for achieving this transformation is offered in the last section of the paper.

Support of Housing and Other Attempts to Allocate Credit as Social Goals.

The Historical Record. Housing was adopted as a social goal in the 1930s, when federal chartering of S&Ls and federal guarantees of home mortgage loans were established. This goal was furthered by the creation of the Federal Home Loan Bank Board as a regulatory agency, and the Federal Home Loan Banks, the Government National Mortgage Association and the Federal Savings and Loan Insurance Corporation as vehicles for diverting funds into home mortgages. The extension of Regulation Q ceilings to thrift associations in 1966 and their continuation at a level below market rates on the savings deposits of all insured depository institutions were justified as means of keeping funds flowing into mortgages. Other means of supporting home ownership were restrictions on the non-mortgage assets in which thrift institutions can invest and the granting of tax benefits if mortgages are above a given percentage of total assets. Most recently, the Home Mortgage Disclosure Act of 1975 and the Community Reinvestment Act of 1977 were enacted to encourage (or force) chartered financial institutions located in older urban areas to make mortgage and other loans in those areas. The former Act is simply a disclosure statute that requires the institutions to identify publicly the volume and type of mortgages made by census tract. The Community Reinvestment Act requires institutions to demonstrate they have adequately served their local communities, particularly when they request permission to open or close branches.

Other attempts to allocate credit that can be mentioned include the Federal Reserve's down payment and maturity requirements for consumer cash loans that have been imposed at various times, margin requirements on loans secured by securities, and moral suasion (or threats) by the Federal Reserve Board designed to get banks to forbear from lending for what the authorities consider to be socially undeserving projects.[36]

The Present Situation. Whether housing should be subsidized, while a valid question, need not be addressed here since the laws and regulations designed to support this industry have not achieved this goal. Indeed there is reason to believe that these constraints have had the opposite effect. These conclusions are based on considerations of the availability and cost of funds for house purchases.

Availability has two dimensions. One is the effect that the number and type of sources have on the quantity (or level) of funds that flow into mortgages. The second is the effect of the variation of the fund flows on house purchases. With respect to the quantity of funds, there is no reason to believe that the required specialization in mortgage lending by a particular set of institutions is either necessary or desirable for funds to flow freely into mortgages. Money is the most fungible of all assets. Mortgage lending requires skills, but there are no barriers or great costs that prevent people from acquiring them or lenders from hiring people who have these skills. As long as there are no constraints on the yields that can be earned by lenders, demands for mortgages will be met by a large number of sources. Even now, people obtain mortgages from mortgage companies and private parties as well as from chartered financial institutions.[37] In addition, people can use their own funds and obtain purchase money mortgages and land sales contracts from the seller (which often are not recorded as mortgages). Furthermore, all of these sources for mortgage funds are available to home buyers in most markets.

Not only are mortgage funds available from many sources, but the evidence does not support the essential assumption that there is a direct and necessary linkage between mortgages and home buying. Mortgages are but one of many means of borrowing money. A house can serve as collateral for funds that are used to purchase other assets. Thus, Dwight Jaffee, who reviewed the relationship between mortgage finance and housing, concludes: "The main effect of developed policies [subsidies and interventions in the mortgage market] has been to extend greatly the use of mortgage debt in the U.S., but without any appreciable payoff in terms of housing investment."[38] From his review of several studies, Allan Meltzer similarly finds "no evidence that the availability of the particular type of credit has any important or lasting effect on the type of assets individuals

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[36] Subsidies to borrowers are a much more important means of allocating credit. These extensive (and expensive) programs include the FHA 221 (d)(2) and 235 programs that provide low interest rate, low down payment loans to lower income persons and other house buyers in declining urban areas, education loans, farm loans and small business loans. The cost of these programs in terms of the difference between market rates of interest and the rates charged to the borrowers has been very great and no doubt has resulted in the shifting of resources to those assets and activities that would qualify for the subsidies. An additional cost is the nonrepayment of the loans. Since these allocations of credit and their associated costs are not an aspect of banking regulation, as such, they are not considered further here.

[37] As an indication of this fact, note that the $1,503 billion of total mortgages and $992 billion of one to four family mortgages outstanding as of June 30, 1981 were held by the following:

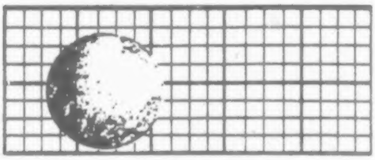
	All	1 to 4 Family
Commercial banks	18.3%	16.8%
Mutual savings banks	6.6	6.6
Savings and loan associations	34.2	43.3
Life insurance companies	9.0	1.8
Federal and related agencies	7.9	6.3
Mortgage pools or trusts	10.1	13.0
Individuals and others	13.8	12.2
Total	99.9%	100.0%

[38] Dwight M. Jaffee, "Housing Finance and Mortgage Market Policy," in *Government Credit Allocation*, Institute for Contemporary Studies: San Francisco, CA., 1975, p. 119.

acquire. If the housing market is the market in which 'availability matters' or matters most, there appears to be very little if any empirical basis for the conjecture on the public policies based on it.''[39]

Variation in the amount of funds available for mortgages, though, is likely to be an important short-run deterrent to house purchases. If a mortgage cannot be obtained, at virtually any price, houses can be purchased by very few people. This situation can occur when thrift institutions dominate mortgage lending in an area because laws and regulations give them a comparative advantage over other lenders. (These advantages may be positive, in the form of tax breaks and other subsidies, or negative, in the form of penalties that other lenders can avoid.) Then, when an event such as an unexpected increase in interest rates results in a reduced flow of funds to the thrift institutions because they are unable to offer the market rate for deposits, a major source of mortgages is cut off. Unexpected increases in interest rates also can result in the failure of the specialized thrift institutions, since they are unable to match the maturity (or duration) of their assets and liabilities. Consequently, they are subjected to capital losses when the value of their assets (mortgages) decreases, but they must pay the market rate on their liabilities (time deposits) or face disintermediation. Such failures obviously reduce the flow of funds to mortgages, at least until other lenders obtain the required skills to meet the demand.

Expected variations in fund flows also tend to reduce the flow of funds to mortgages. In this situation, lenders usually find it desirable to maintain assets that can be sold and purchased at relatively low transaction costs. Nonspecialized lenders can hold a mix of assets and liabilities where the expected fund flows tend to offset each other. Since, until recently, thrift institutions generally were not permitted to invest in consumer and business loans and obtain checking account deposits, they tended to hold bonds as a buffer stock (secondary reserve). In those states (such as Connecticut) where the mutual savings banks could hold consumer loans, the institutions tended to hold relatively fewer bonds and more mortgages.[40] Hence, enforced specialization tended to reduce the flow of funds to mortgages.



Turning now to the cost of mortgage funds, it is obvious that the greater the number of lenders vying to make mortgages, the lower the cost to mortgagors. And, the greater the variation of funds to lenders and borrowers, the greater the costs to both. Therefore laws and regulations that restrict entry into the mortgage market and that require financial institutions to specialize in mortgages tend to increase the cost of mortgages.

A final question that should be considered is whether subsidies to thrift institutions in return for their specializing in mortgage lending are likely to be supportive of housing (whether these subsidies are otherwise justified). The subsidies take the form of lower taxes and legally imposed limits on the amounts that can be offered to depositors (Regulation Q). As is discussed above, the first form of subsidy is likely to increase the variation and reduce the flow of funds available for mortgages because of the enforced specialization of the institutions in mortgages and the reduced incentives of other lenders to make this type of loan (witness the virtual withdrawal of life insurance companies from 1 to 4 family unit mortgages). The second is only temporarily useful, even if one assumes that the lower interest rates paid to depositors are passed on to home buyers. As we have seen in the past and are witnessing today, when market interest rates are above the Regulation Q ceilings, disintermediation occurs. The enormous growth of money market mutual funds are due entirely to the desire and ability of savers and enterpreneurs to get and offer the best return on funds. But, unfortunately for those who want to obtain mortgages, the savers who take thei. money out of the thrift institutions that specialize in the mortgages and purchase money market mutual funds shares are actually redepositing their funds principally in commercial banks and are financing corporate and government borrowing. The money market mutual funds tend to hold commercial paper, U.S. treasury issues and the certificates of deposit (CDs) of large commercial banks. They hold these CDs because only CDs over $100,000 can bear market rates of interest and CDs of these amounts are not guaranteed by the FDIC. Hence, the funds would be foolish to risk investment in the CDs of thrift institutions, many of which are in danger of bankruptcy, or of smaller commercial banks, about which information is more expensive to obtain and which are more likely to be permitted by the FDIC to fail than are the very large banks.

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[39] Allan H. Meltzer, "Credit Availability and Economic Decisions: Some Evidence from the Mortgage and Housing Markets," in *Ibid.*, p. 149.

[40] See George J. Benston, "Savings Banks and Public Interest," *op. cit.*, pp. 174-176.

The effectiveness of directing credit by regulation toward other specified assets and borrowers has also been found to be slight and often dysfunctional. A number of these studies are surveyed by Thomas Mayer, who concludes: "As the above has shown, credit allocation is not an efficient system. The shifts in the distribution of credit which it tries to bring about are of doubtful value, and, in any case, credit allocation would be ineffective in the long run."[41] When the controls are effective (in the short run), they cause borrowers and lenders to incur the costs of complying with and attempting to avoid the controls. While some borrowers are advantaged and some set of social goals advanced, the effect, at best, is temporary. At worst, the benefits do not flow to those who are presumed to be aided, but to others who are more adept at using regulations to their advantage.

With such credit allocation laws as the Community Reinvestment Act of 1977, harm rather than good is likely to be done to those for whom the law presumably is directed. The law requires chartered financial institutions to direct loans to mortgages on local houses and businesses, particularly if these are in older, blighted areas. If lenders would make these loans without the law, compliance costs are needlessly imposed. If these loans would not be made because the risks exceed the interest rates that can be charged (given institutional or legal constraints), the law encourages institutions to leave the area and discourages others who are similarly regulated from opening branches in the area. In either event, while the volume of loans flowing into the area may be increased initially, the funds will tend to be directed toward the least risky borrowers. As lenders can adjust to the situation, consumers in the area will find fewer sources of funds and other banking services.[42] The law will benefit consumers only if bankers had been discriminating against borrowers for noneconomic reasons and, as a consequence of the law, they were led or forced to give up their taste for discrimination. With respect to mortgages particularly, almost all of the empirical studies find no evidence of discrimination against persons or areas (redlining).[43]

Prevention of Invidious Discrimination and Unfair Dealing Against Persons

The Historical Record. Laws that explicitly prohibit invidious discrimination in the provision of banking services (especially loans) were first enacted in 1968.[44] The Fair Housing Act of 1968 prohibited banks and other lenders from denying mortgages or home improvement loans on account of a person's race, color, religion, sex or national origin. The Equal Credit Opportunity Act (Title VII of the Consumer Protection Act—CCPA— of 1968), enacted in 1974 and amended in 1976, added prohibitions against all credit discrimination on the grounds of age, race, religion, national origin, receipt of public welfare benefits and exercise of rights under the CCPA. The Federal Reserve's Regulation B supplements the law. Regulations written under the dictates of the Community Reinvestment Act of 1977 forbid the alleged practice of denying mortgage and home improvement loans on properties solely because they are old or are located in older areas (redlining).

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[41] Thomas Mayer, "Credit Allocation: A Critical View," in *Government Credit Allocation*, Institute for Contemporary Studies: San Francisco, CA.: 1975, p. 91.

[42] For a further analysis, see George J. Benston, The *Anti-Redlining Rules: An Analysis of the Federal Home Loan Bank Board's Proposed Nondiscriminatory Requirements*, Law & Economics Center, University of Miami School of Law: Miami, FL., 1978.

[43] See George J. Benston, "Mortgage Redlining Research: A Review and Critical Analysis," in *The Regulation of Financial Institutions*, Conference Series No. 21, October 1979, Federal Reserve Bank of Boston, pp. 144-195, and *Journal of Bank Research*, 12 (Spring 1981), 8-23.

[44] See Ralph J. Rohner, "Problems of Federalism in the Regulation of Consumer Financial Services Offered by Commercial Banks," in *State and Federal Regulation of Commercial Banks*, Leonard Lapidus and others, Federal Deposit Insurance Corporation, 1980, Volume II, pp. 1-168, especially 16-75 for a good description of the federal and state laws and regulations.

Several laws are directed at providing borrowers with complete information and forbidding certain practices in the belief that without these laws borrowers would be victimized. The Truth-in-Lending Act of 1968 (Title I of the CCPA) requires disclosure of credit costs and terms on consumer loans and long-term leases of consumer goods. It also regulates the content of credit advertising, and regulates credit card distribution, terms and liabilities. The provisions of the Act are implemented by the Federal Reserve's detailed and lengthy Regulation Z. The Electronic Fund Transfer Act (Title IX of the CCPA), enacted in 1978, requires disclosure of account terms, documentation of transfers and prompt error resolution, limits the consumer's liability for unauthorized transfers, and imposes liability for unauthorized transfers by financial institutions. The Real Estate Settlement Procedures Act, adopted in 1974 and amended in 1976, requires mortgage lenders to provide borrowers with a statement of actual charges, forbids kickbacks of settlement fees and tie-ins of sales of title insurance, and limits escrows for taxes and insurance. The Right to Financial Privacy Act of 1978 restricts the right of government agencies to gain access to a consumer's banking records.

Finally, some lending and collection practices of creditors are constrained or prohibited by various laws. The Fair Credit Reporting Act (Title VI of the CCPA), passed in 1970, regulates the content, accuracy and disclosure of credit and investigative reports furnished to creditors, employers and insurers in connection with consumer transactions. Title III of the CCPA establishes a minimum level of wages that are exempted from garnishment and prohibits an employer from firing an employee because of a single garnishment. The Fair Debt Collections Act (Title VIII of the CCPA), enacted in 1977, prohibits abusive and coercive collection practices and requires bill collectors to provide debtors with certain information. It applies to banks only in-so-far as they collect the debts of other lenders. In addition, the Federal Trade Commission's holder-in-due-course rule, issued in 1975, effectively abolished this protection for banks which discounted consumers' notes made to retailers.

In addition, the states have enacted laws that similarly regulate credit practices. Some of these parallel the federal Truth-in-Lending and Equal Credit Opportunity Acts. In several states, notably California, the anti-redlining regulations are more severe than the federal regulations. Most states have usury statutes that stipulate the maximum interest rate that can be charged on various types of loans. These laws are quite diverse and complex. The Uniform Consumer Credit Code, promulgated in 1969, has been adopted by only six states, and they changed various provisions. (In contrast, the Uniform Commercial Code has been adopted virtually intact by almost all states.) Finally, the laws of various states restrict creditors' collection remedies more severely than do the federal statutes. These restrictions on contractual provisions include prohibitions against confession of judgment clauses or cognovit notes, restrictions on collateral available as security, restrictions on deficiency judgments following repossession and limitations on cosigner agreements.

The Present Situation. Assuming (as I do as an ethical value) that invidious discrimination against individuals should not be permitted as a matter of social policy, two questions related to the laws and regulations should be considered. First, are these laws effective in eliminating or reducing invidious discrimination at a cost that is not excessive? Second, is the particular way in which these laws are enforced preferable relative to alternatives? While answers to these questions appear to require value-based assumptions about the meaning of the words "excessive" and "preferable," important aspects of the answers need not await agreement about their operational meaning.

A preliminary question, though, is whether invidious discrimination by financial institutions was a serious problem before the laws were enacted. If such were not the case, the laws simply impose costs on the institutions and their customers without yielding benefits to those whom the laws purport to help. Passage of The Equal Credit Opportunity Act was supported by testimony before the National Commission on Consumer Finance and before Congressional committees that described incidents of invidious discrimination in lending to women.[illegible] However,

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[illegible] National Commission on Consumer Finance, *Consumer Credit in the United States: Report of the National Commission on Consumer Finance*, Superintendent of Documents, U.S. Government Printing Office, Washington, D.C., 1972, pp. 153-156.

any activity, including credit granting, is conducted with some error and insensitivity. When these occur to women, blacks or other persons who have experienced invidious discrimination in other situations the refusal of credit is likely to appear to have been deliberate and unfair. Since testimony by men and whites who were turned down for loans was not heard, it is not possible to know whether the lenders systematically practiced discrimination.

Several studies have been conducted since the hearings that find no evidence of invidious discrimination against women. Chandler and Ewert examined the records of slightly over 2000 credit card applicants at a large metropolitan bank, drawn from applications made between 1971 through early 1974, prior to the passage of the Equal Credit Opportunity Act (ECOA).[46] They constructed credit scoring models to determine the effect of using or not using an applicant's gender as a variable in rejecting or accepting applicants and, if the applicant was accepted, whether the person would be predicted to be a good or bad (loss) payer. They found that when the applicant's gender was included as a variable 22% more females would be accepted compared to excluding gender as is required by the ECOA. Among those accepted, use of gender would have identified 19% more good payers and the same number of bad payers.[47] Thus, if these data are typical, the ECOA regulations tended to make credit cards more difficult to obtain for females and to have imposed greater losses on lenders.

The question of whether commercial banks discriminated against female small loan borrowers before enactment of the ECOA was studied with data obtained by the Federal Reserve from 30 banks in five regions, each consisting of a major metropolitan area plus surrounding environs.[48] Randomly selected data from the pre-ECOA period of 1966-71 included 3,000 charged-off, 12,000 good paid-off and 13,500 new direct consumer loans. These were analyzed with a well-specified model to see if commercial banks systematically discriminated against one sex or another in granting consumer credit by over-securing loans, thereby reducing loss ratios and probabilities, credit-rationing to reduce loss probabilities or charging higher rates to certain borrowers based on sex. The study found: "Overall, the tests provided extensive evidence that commercial banks did not discriminate against potential borrowers based on their sex before ECOA (Equal Credit Opportunities Act) was passed."[49] The only other studies of which I am aware consider possible invidious discrimination in mortgage lending related to the area in which the home is located (redlining) or the race or other personal characteristics of the actual or potential mortgagor. With one exception, all of these find no evidence of invidious discrimination in the denials of loan applications, the types of loans made or the terms charged.[50]

Thus the empirical analyses do not find evidence of discrimination in lending by financial institutions in the years before or after the laws prohibiting such discrimination were enacted. This result is not surprising if one views lenders as people who prefer to maximize their wealth. If they are bigots and if they and their shareholders are willing to accept lower rewards (and it is likely that some are, considering that more than a few people speak and act in this way), it seems unlikely that they would indulge this taste on people with whom their principal contact is a loan agreement and the receipt of repayments (usually by mail).

While the benefits to those who are supposed to be protected by the anti-discrimination acts at best appear to be negligible (and possibly are negative), the costs to financial institutions (and therefore, to their customers) are substantial. James Smith estimated these for compliance with the Federal Reserve's Regulation B that implemented the anti-discrimination provisions of the ECOA.[51] He included the non-recurring costs of legal fees, training and obsolete form removal and the additional costs of printing and

[46] Gary G. Chandler and David C. Ewert, "Discrimination on the Basis of Sex Under the Equal Credit Opportunity Act," Working Paper No. 8, Credit Research Center, Krannert Graduate School of Management, Purdue University, 1976.

[47] Ibid., Table 6, p. 16. The figures are for a .75 cutoff score (a number that determines how stringently credit is granted). At higher cutoff scores (to .80), relatively more applicants are accepted (including bads that should have been rejected). At lower cutoff scores (to .55) the relative differences decline, but even then more rejected female applicants would be accepted, and more good and bad applicants identified.

[48] Richard L. Peterson, "An Investigation of Sex Discrimination in Commercial Banks' Direct Consumer Lending," *The Bell Journal of Economics*, 12, Autumn 1981, 547-561.

[49] Ibid., p. 560.

[50] George J. Benston, "Mortgage Redlining Research: A Review and Critical Analysis," *op. cit.*

[51] James F. Smith, "The Equal Credit Opportunity Act of 1974: A Cost/Benefit Analysis," *Journal of Finance*, XXXII (May 1977), pp. 609-622.

mailing notices, changing systems, and handling responses due to the requirement that women be informed that they can establish separate credit records. These costs are estimated to be $88.6 million for financial institutions (commercial banks, thrift associations, credit unions and finance companies) and $78.8 million for merchants (retailers, oil companies and other credit card issuers). Recurring costs include increased losses, collection expense and record retention costs. These annual costs are estimated to be $68.8 million for financial institutions and $58.7 million for merchants.

Chartered depository institutions are subjected to additional costs in the form of compliance examinations. Rohner reports that in the fiscal year ended June 1978, 9117 compliance examinations were conducted and $7.1 million was spent by the federal banking agencies (FDIC, Federal Reserve and Comptroller of the Currency).[62] Additional examinations and expenditures were made by state agencies. In addition, the banks incurred additional costs related to the examinations, including the cost of special computer runs, time spent with examiners, and the opportunity cost of constraints on banking operations that examiners might question. Indeed, bankers are reported to find these examinations particularly costly and of very limited benfit to consumers. In a study of the opinions of banks, regulators and consumer specialists toward federal and state regulation, Gloria Elhat elicited opinions on the following aspects of consumer protection: Credit discrimination, disclosure, community reinvestment, creditor practices and remedies, and regulation of loan terms (interest rates, maturities and amounts).[63] She reports most (from 70% to 90%) of the bankers saying that compliance with the consumer protection laws are "very or quite" costly and were not important in protecting consumers.[64] The regulators and examiners interviewed tended to agree with the bankers (though they were not as strongly negative, particularly with respect to the importance of the limitations on creditor practices). Not surprisingly, the professional consumer advocates were of the opposite opinion. Thus all except the consumer advocates believe that the consumer protection laws as administered are considerably more costly than beneficial. Assuming, though, that these laws are not repealed, it seems clear that they can be administered in a more efficient and more equitable manner than by compliance examinations. This issue is considered further below.

CONTEMPORARY REASONS FOR AND METHODS OF REGULATING BANKING — A RECAPITULATION

No Longer Relevant Reasons

Taxation. Restriction of entry as a means of enhancing taxes, the initial reason for bank regulation, is no longer relevant. (The effect of differential taxation of depository institutions compared to other suppliers of banking services is discussed below.)

Prevention of Centralized Power. Restriction of entry for this purpose also is no longer relevant, if it ever was. In particular, there is no reason to believe that the removal of all restrictions on branching or holding companies would result in the demise of small, locally-owned banks. Indeed, if further decentralization of banking services is desired, all legal restrictions on entry and the provision of services, by banks as well as other enterprises, should be removed.

Bank Solvency and the Effects of Failures on the Economy. The requirement of deposit insurance has eliminated concerns about bank runs and the consequent effects on the economy. While bank failures, as such, are not desirable, they now are likely to be somewhat less disruptive on employees, customers and local economies than are the failures of most other types of enterprises. Therefore, special government supervision of financial institutions (with the possible exception of mutuals) is no longer justified for this reason.

The Social Goal of Available Banking Services. Regulations that prevent or impede organizations from providing services to the public violate this social goal. Consequently, such constraints as limitations on the banking services that thrift institutions can provide, securities services that commercial banks can offer and interest that can be offered to depositors, are undesirable. There also no longer is any reason to subsidize the payments mechanism by maintaining it as a Federal Reserve operation.

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[62] Ralph J. Rohner, *op. cit.*, p. 107.

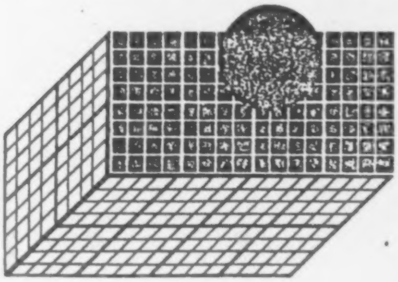
[63] Gloria A. Elhat, "The State and Federal Regulation of Banks: Interpretive Analysis and Principal Findings of a Survey of Bankers, Regulators and Consumer Specialists," in *State and Federal Regulation of Commercial Banks*, Leonard Lapidus and Others, Federal Deposit Insurance Corporation, Washington, D.C.: 1980, pp. 406-424, 492-502, 542-557.

[64] Similar findings are provided by a "representative nationwide sample of 1585 chief executive officers of national, state member and state nonmember banks" conducted in 1979 by the FDIC. An average of 91 percent said these examinations were "very or quite costly." Randall J. Miller, "On the Cost of Double Supervision for Insured State Chartered Banks," in Leonard Lapidus and Others, *Ibid.*, pp. 379-380.

Support of Housing and Other Attempts to Allocate Credit. It is unlikely that enforced specialization of thrift institutions as providers of mortgages benefits the production and sale of houses. To the contrary, such specialization tends to increase the variance of fund flows into mortgages, which works a temporary hardship to those who want to buy and sell houses. Interest rate ceilings on deposits and mortgages also restrict the flow of funds to mortgages. Credit directing legislation, particularly the Community Reinvestment Act, raises the cost of lending and is unlikely actually to direct a greater flow of funds to the presumably favored borrowers, except perhaps in the very short run. Such legislation, though, tends to raise costs to bank customers and allocate resources inefficiently. Consequently, if support of the housing market is a social goal, the existing regulations on lenders and prices should be removed.

Possibly Relevant Reasons

Taxation. If the government wants to levy a tax on bank-supplied money, it can do so efficiently by requiring all enterprises that supply this product to maintain a given percentage of the relevant deposits as non-interest bearing reserves with the Federal Reserve. With the exception of equality of reserve ratios among enterprises (larger banks are required to hold higher percentages than smaller banks), this procedure is presently being followed. Any regulation on entry, products supplied, interest paid or charged, etc. would either be unnecessary or counter-productive, since anything that impeded or made more costly the supply of bank-money would favor non-taxed substitutes, such as credit cards.



Money Supply Control. The Federal Reserve can exercise control over the money supply by requiring all suppliers of third-party transfers (demand deposits and close substitutes) to maintain reserves and, possibly, to report statistics. Alternatively, the Federal Reserve could control the money supply simply by predicting the effect of open market operations, on the assumption that the relationship between voluntarily held reserves and money is predictable. In either event, unexpected changes in the money supply and velocity can be reduced by making substitutes for specified third-party transfers less desirable. This can be accomplished by removing the tax on required reserves represented by the opportunity loss on these presently non-interest bearing funds. At the same time, tax subsidies to banks should be removed.

Avoidance of Competition. Regulations that restrict entry are particularly beneficial to those providing a product or service. Thus the present requirement that those who would open banks must obtain a charter, the granting of which is not automatic even if some basic qualifications are fulfilled (such as the obtaining of deposit insurance), provides an opportunity for existing bankers or other competitors to raise objections. Restrictions on inter-state and intra-state branching also serve to reduce competition. Competition is reduced further by laws and regulations that restrict thrift associations from providing a wide range of banking services (most of which have now been removed or reduced), prevent commercial banks from providing securities services, impose interest rate ceilings on deposit accounts, and restrain non-chartered enterprises from providing depository banking services. Indeed, restraining competition is a very relevant past and contemporary reason for regulation. However, as the advantages from avoiding restrictions grow and as technological change and innovations reduce the cost of avoiding the laws and regulations, the contraints serve predominantly to raise costs to consumers with fewer and fewer benefits to the increasingly less protected producers.

The Protection of Depositors and Bank Solvency. Since the creation of the FDIC and the other federal deposit insurance agencies, this concern is relevant only in-so-far as the requirement of deposit insurance tends to restrict competition and innovation and increase the cost to consumers of credit and other banking services. Solvency, as such, is a currently relevant regulatory problem only for mutual associations, and then only because there are no stockholders and securities market to discipline wayward managers.

Prevention of Invidious Discrimination and Unfair Dealing Against Persons. The legislative history indicates that this concern is currently relevant, even though there is no scientifically acceptable evidence that supports the underlying belief that financial institutions invidiously discriminated, at least in recent times. The present procedure of compliance examinations, though, is neither cost-effective or fair. Further discussion and an alternative method are presented below.

RECOMMENDATIONS

Regulatory Agencies

Comptroller of the Currency. Other than as a means of allowing existing suppliers to avoid competition, there is almost no purpose served by requiring those who would provide banking services and banks which would provide other services to obtain regulatory permission. But, since state laws require banks to have charters, and since depository insurance is desirable to protect banks from runs and depositors from losses, the Comptroller of the Currency (and the Federal Home Loan Bank Board) should be directed to provide charters to any corporation that offers demand deposit or similar services to the public as long as it has obtained satisfactory insurance. The Comptroller (or the FHLBB) also would issue permits to foreign banks to have offices in the United States. The only conditions imposed on these banks would be that they have deposit insurance comparable to that required of U.S. banks. The Comptroller also would be responsible for getting foreign countries to accept U.S. banks' offices. The principal function of the Comptroller, then, would be to evaluate and approve a list of insurance companies and be assured that coverage is maintained. Examination and other supervisory functions are the concern only of the insurers.

Federal Home Loan Bank Board. The functions of this agency are similar to those of the Comptroller of the Currency. Its continued existence is justified for two reasons. First, it provides potential and present federally chartered deposit providers with an alternative to the Comptroller of the Currency. The ability of banks to switch to another chartering agency, even if seldom exercised, constrains the agencies somewhat from attempting to expand their control. Second, the FHLBB administrators have experience in dealing with thrifts and with mutual associations. Therefore, until this situation changes, the FHLBB would charter mutual savings and loan associations and mutual savings banks. If these institutions should wish to convert to stockholder status, this agency would be charged with seeing that the public was not cheated. This could be accomplished by supervising the sale of stock by the mutual institutions, the proceeds of which would be returned to the U.S. Treasury (since a large portion of the equity in the associations is due to favorable tax laws and protective regulations).[35] For those institutions that remain mutuals, the FHLBB would provide residual authoritative control, should it be necessary to remove or discipline incompetent or dishonest officers.

Federal Home Loan Banks. These institutions already operate as if they were privately owned banks. They should be considered as such, with ownership transferred entirely to the member associations in the form of marketable stock. At this point, there is no reason for them to be treated differently than other banks, particularly with respect to taxation and Treasury guarantees of their debt obligations.

National Credit Union Administration. Since credit unions are mutuals and often operate as charitable or fraternal organizations, some chartering and residual administration is likely to be necessary. These services would be provided much as they are now.

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[35] Some compensation in the form of founders' stock also should be awarded to the officers of the mutuals whose efforts were responsible for a portion of the equity and who would lose if control of their associations passed to stockholders.

The Federal Reserve Board. The Fed should function solely as a central bank that is concerned only with control of the money supply and the collection of statistics that are considered necessary for this and other governmental tasks. Membership in the Federal Reserve has been an anachronism for some time (roughly not long after the Fed was founded as a government bank rather than as the originally intended bankers' bank). With the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, which required reserves of all depository institutions and allowed them access to the Fed's services, membership now has almost no meaning. Hence, the Fed should forego its examinaton and supervision of state member banks.[56] Since there is no present purpose (other than restrictions on competition) of bank holding company legislation and since there is no reason to treat bank mergers as different than any other type of mergers, these aspects of Federal Reserve bank supervision are not required.[57]

The Federal Reserve's payments system should be set up as a private corporation, with the marketable stock distributed to the member banks in exchange for their stock in the Federal Reserve. The Fed's related buildings, equipment, other assets, liabilities, and personnel should be ceded to this new corporation.

Since it controls base money, the Fed would continue to be the "lender of last resort." Its borrowing facilities would be available to all institutions that maintained reserves with it. Should an institution wish to borrow reserves, it could do so only at a penalty rate. Furthermore, the institution's deposit insurance company would have to be notified and its objections (if any) would have to be considered since the insurer bears the cost of a failure.

The Federal Reserve, then, would only maintain the reserves of providers of third-party transfers, transfer balances upon request by the newly private payments system corporation and banks that have reserves at the Fed, issue currency (at a fee) to banks and others, continue to collect statistics and serve as the lender of last resort. This reduction in responsibility would free it to improve its management of the money supply.

Depositors' Insurance

All institutions that offered funds transferred on demand would be required to have depositors' insurance. The insurance companies would have the responsibility of estimating the risk assumed and setting the insurance fees. By agreement with the institutions in which depositors' accounts are insured, the companies might conduct field examinations and maintain the power to remove officers, issue cease and desist orders, and have the institutions' stockholders increase their investments. The deposit insurers' powers and responsibilities would be similar to those of other insurance companies, with the practices employed tailored to the risks undertaken.

To control the insurers' power and work toward greater monitoring efficiency, depository institutions should be permitted to purchase insurance from any company approved by their chartering agency. These companies would include the FDIC, FSCIC and NCUSIF. They would remain government agencies, at least for the present. But other private companies, including banks, could enter the market. As a consequence of competition, the insurers have an incentive to set the fees charged and conduct examinations in an efficient manner. If they conduct unnecessary or inefficient examinations and fail to adopt cost-effective procedures for assessing risk and keeping the insured institutions from engaging in overly risky and potentially fraudulent behavior, the institutions have an incentive to get insurance from another agency or company. But if the insurers do not institute effective controls, they bear the costs of failures and frauds. Given this incentive, there is no role for the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Home Loan Bank Board or the National Credit Union Administration to play (except as noted above for mutuals).

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[56] For an analysis that concludes that bank supervision and examination is unrelated to money supply, interest rate or credit control, see George J. Benston and John Tepper Marlin, "Bank Examiners' Evaluation of Credit: An Analysis of the Usefulness of Substandard Loan Data," *Journal of Money, Credit and Banking*, VI (February 1974), pp. 23-44.

[57] See Merton H. Miller and Richard A. Posner, "An Approach to the Regulation of Bank Holding Companies," *Journal of Business*, Vol. 51 (1978), p. 379-411, for a review of the law and the arguments for and against special regulation.

Bank Holding Company Regulation

Bank holding companies presently are regulated by the Federal Reserve. Since the affiliated banks may be chartered by states and by the Comptroller of the Currency, this regulatory structure is subject to inter-agency conflicts and inadequate supervision.[38] In addition, the Federal Reserve has the responsibility of approving multi-bank holding company acquisitions but not the authority to grant charters or approve branches, both of which could offset the possible anticompetitive effects of a reduced number of independent banking firms.

If the recommendations set forth here are adopted, these problems will disappear. Entry will be essentially unrestricted and banks will no longer be supervised, except by their insurance agency or company and by the same authorities that are concerned with other enterprises (e.g., the SEC and the Justice Department). The deposit insurer, which is concerned that the insured bank does not waste its assets, may look to the bank's arrangements with its parent (if it is a subsidiary corporation) and with related corporations. (Similarly, the insurer would be concerned about any arrangements that are likely to be conducted at less than arm's length.) Furthermore, the insurer probably would want the distinction between the insured bank and non-insured related companies to be clear to the public, perhaps by insisting on quite different names. In any event, neither the Federal Reserve nor any other banking agency would have a role to play.

Anti-Discrimination and Other Consumer Protection Laws

Economic reasoning and evidence supports the conclusion that consumers are protected best by competition among suppliers for the consumers' trade. Therefore, the social objective of benefiting consumers will be served by removing legal barriers to entry and inefficiencies that raise costs to consumers, as is recommended above. Laws that make invidious discrimination against consumers illegal and that specify how credit terms are to be stated and which specified collection practices may not be required additionally.

But the anti-discrimination laws serve a symbolic function as well as provide a basis for the legal authorities to investigate and act on consumer complaints. And the credit practice laws may be justified as protecting ignorant and powerless consumers from a relatively few unscrupulous suppliers (though such scoundrels usually are quite willing to break the law). However, if the laws are to be effective and fair, they should apply to all suppliers of credit and other banking services. Financial institutions clearly are not the sole suppliers of these services, and if the recommendations made herein are adopted, they will be even less so. Indeed, more consumer credit is supplied by retail stores, mortgage bankers, consumer finance companies and sales finance companies than by depository institutions.

The present difference in the application of anti-discrimination and credit practices laws among suppliers of credit is that only the depository institutions are subjected to compliance field examinations. Not only is this difference in administration unfairly burdensome to a sub-set of credit suppliers, but there is no reason to believe that the result is beneficial to consumers. The costs of the examinations are considerable, both for the examining agencies and for the institutions examined. Furthermore, because depository institutions tend to serve more highly educated and wealthier individuals than do other suppliers of credit, laws designed toward protecting the ignorant and powerless should not be applied more stringently to them than to other suppliers. On the possible benefits side, studies have found no evidence of discrimination in credit granting by banks before the laws were enacted nor (to my knowledge) have studies been publicly released that show improvements. Furthermore, the use of field examinations to determine whether a law has been violated is contrary to most U.S. legal practice. The only other similar instances of which I am aware are field examinations for violations of health laws. These are justified as preventing damage to consumers for which compensating damages would not be adequate. But such is not the case for violations of anti-discrimination laws. Therefore, field compliance examinations of depository institutions should no longer be conducted. The authority and responsibility for enforcing the anti-discrimination and other consumer protection laws should be vested in the Justice Department or the Federal Trade Commission.

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[38] These problems and some case studies are reviewed by Bernard Shull, "Federal and State Supervision of Bank Holding Companies," in *State and Federal Regulation of Commercial Banks*, by Leonard Lapidus and others, Federal Deposit Insurance Corporation, Washington, D.C., 1980, Volume II, 271-374.

Taxation

Resources tend to be inefficiently allocated when alternative suppliers of goods are subjected to different degrees of taxation. This is the situation for suppliers of deposit services. Because the reserves required against deposits held by the Federal Reserve banks do not bear interest, the suppliers and thus the users of bank money are subjected to a special tax. This tax could be removed by having the Federal Reserve pay interest on the reserves.[48] However, two other important differences in taxation should be mentioned and considered. One is that hand-to-hand currency does not, and in practice cannot, bear interest. Furthermore, if the government chooses to tax with inflation, there is no reason to give part of this tax to the suppliers of bank money via the multiple expansion of deposits. Therefore, some tax on bank money is equitable and efficient. Second, present tax law permits banks, and only banks, to deduct against taxable income the full cost of funds used to purchase interest tax-free state and municipal bonds. (These costs include the operations costs of processing demand deposits less fees charged plus explicit interest payments and implicit payments in the form of lower loan and other charges to depositors). A careful study of the incidence of these taxes and benefits is beyond the scope of this paper. But if taxes on all suppliers of banking services are to be equalized, such a study is necessary (though given political reality, unlikely to be sufficient).

Repeal of Laws

A number of laws should be repealed or suitably amended to remove federal restrictions from financial institutions, as specified above. These laws include the McFadden-Douglas Act, The Banking Act of 1933 as it pertains to bank regulation, The Bank Holding Company Act and The Community Reinvestment Act. Regulations that set ceilings on interest payments and charges (either on demand or time deposits on loans) and that call for compliance field examinations also should be rescinded.

The effect of the changes suggested above on the dual banking system should be mentioned. The states still will have the power to charter banks. They also might choose to examine and otherwise regulate them, but that would be a waste of resources since there is no public interest in this activity. Rather, the states' principal role will be to assure the residents that if the Comptroller of the Currency ever limits the institutions that would serve the state, there is an alternative source of charters. In addition, the states could impose regulations and taxes on banks much as they do on other companies that do business in their jurisdictions.

Conclusion

The suggested removal of almost all legal restrictions that especially constrain financial institutions is based on the underlying assumption that the purpose of regulation is to benefit consumers rather than producers. The historical analysis presented above shows that most of the reasons for regulating banking are no longer relevant. Furthermore, credit is supplied by a very large number of other enterprises, including retail stores, gas stations, mortgage bankers, security brokers, commercial paper dealers, pension funds and insurance companies. Except for the possibility of runs and the propensity of financial intermediaries to be defrauded, banks are no different from other businesses. Consequently, only the requirement that providers of third-party transfers (checking accounts) have deposit insurance should be imposed. Also, the laws forbidding invidious discrimination against individuals and protection to consumers should be reconsidered and, at the least, applied equally to all credit suppliers, and taxes imposed on all suppliers should be equal. Only those suppliers that benefit from keeping the constraints on competition and regulators whose domains would be reduced should object. ☐

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[48] Alternatively the Fed could allocate its portfolio of interest-bearing Treasury obligations to the reserves, which is equivalent to paying interest on the balances and may be more acceptable politically.

REASONS FOR BANKING REGULATIONS

Mr. **Benston**. Essentially I identified nine reasons why we have banking regulation. Five of these are no longer relevant and several of the four are, but only to a limited extent.

First, basically, in terms of the five, I will go over them very briefly simply because they're published elsewhere and we have little time. The major reason banks were regulated was so the sovereign had a method of taxing money. He wanted to constrain entry into banking to get a monopoly situation, thereby enhancing the profits that a bank can make and which the sovereign can take either by forced loans or by ownership of shares in the bank. That reason for regulation is not relevant to the United States.

The second reason is prevention of centralized power, which people keep talking about, but is totally irrelevant to the United States at the present time. We have tens of thousands of institutions that provide all kinds of financial services in competition with each other. We still have constraints on this competition, but they're mainly the constraints imposed by branching regulation and by product regulation.

So if we are concerned about centralized power, our concern would be to remove regulations, not to impose them any further.

Banks' solvency, which was a major problem, is no longer a problem for the simple reason that we have FDIC and FSLIC insurance. When I say it's no longer a problem, I don't mean not a problem for anyone. I mean not a problem for most depositors and, hence, not a cause of bank runs, of major collapses that run through the economy, something that was very serious in our history.

The provision of banking services as a social goal was once important. Now it's pretty difficult to walk down the street past a bank and murmur "I wish I had a bank account" and not get yanked inside. Virtually everyone has one, two, or three, and the only problem is that, if the banks ever stop competing, the Post Office would have a big deficit.

The other reason is allocation of credit to housing and various other things, but our experience with those attempts has indicated that they don't work. In fact, what happens with the regulation, is that it constrains people from competing for these funds and makes the flow of funds to housing very variable and uncertain, which is really damaging to the housing market. So the regulations have been detrimental, although initially they were beneficial for that market.

What are we left with? Money supply control, prevention of invidious discrimination against people, avoidance of competition, and the protection of deposit insurance funds.

Money supply control is clearly important, but banking regulation has nothing to do with it. The Federal Reserve's argument that it has to be involved in banking regulation for control of the money supply is at best laughable. If the Fed is concerned with lending money to banks, it has the same problem any bank has in lending money to anybody; namely, it wants to find out about that bank at that time, not continuously. The Fed has enough to do with trying to control the money supply and understand the effect on interest rates on the economy. If the Fed wants to have a constituency, that's understandable, but their interest really is limited to that.

We now get down to the invidious discrimination. We have the Equal Credit Opportunities Act and similar acts which I think most of us would think is very much desirable. The only question is whether this goal of preventing discrimination against persons is best accomplished through regulation such as field examinations and compliance examinations. If we think that such things are important, then one ought to question why such examinations are not conducted against all other grantors of credit—department stores, nonbanks, insurance companies, et cetera, especially when the record is that the banks probably do practice less invidious discrimination than most other lenders. We also should determine whether the benefits to consumers offset the costs to consumers of the legislation and the way it's implemented.

COMPETITION AND SOLVENCY OF THE INSURANCE FUND

We come to the last two reasons—competition and the solvency of the insurance fund. I mention competition first because that is the most important and yet the least that is likely to be affected.

The major reason I think we've had bank regulation and still have it is for the reasons that Carter Golembe said, namely, it makes it possible for people to exclude their competitors. The effect of the Glass-Steagall Act is to make it possible for underwriters to exclude banks from their turf. The restrictions on powers do the same thing. The restrictions on branching are almost entirely related to that, especially since our experience with branching shows the antibranching legislation to be one of the major reasons for the multiple bank failures in the 1930's. Almost all of the banks that failed were unit banks that weren't able to diversify sufficiently.

We get down to the insurance funds. I think we have a very serious problem there, which I'll get into in just a moment.

In terms of the specific changes in regulations that would be desirable, I might also draw your attention to a conference, that I happened to direct, run by the American Assembly last April on the future of American financial services, which produced a report and a volume of work with contributions by many of the people on this panel.

The conference took place over 4 days, with four meetings of over 3 hours each of groups of 20. The people there were virtually all the directors of the banking associations, bankers of large and small banks, people from the insurance industry and the securities industry, congressional staffers, academics such as ourselves. We met together for 4 days with a structured agenda, and eventually came out with a consensus statement that was voted on line by line.

Effectively, what that statement ended up concluding—and I don't think it's where we would have been in the beginning—is essentially that there should no constraints on provision of financial services other than that institutions that accept governmentally guaranteed deposits should not be allowed to be involved in nonfinancial businesses—just that constraint—and vice versa; and that Government insurance basically could be private, or Government, or a combination thereof and it needn't be on deposits that were otherwise secured with marketable, short-term securities.

There should be no constraints on mergers or branches, no controls of interest rates charged or paid, the Federal Reserve should not be directly involved in the supervision of the depository institutions except as necessary for monetary control, no reserves required against deposits or interest should be paid on required reserves, and the costs of consumer protection legislation should be considered with respect to the possible benefits.

I would suggest that, first, all legislation that constrains entry into the provision of financial services either by institutions or by products should be repealed. There's no point to those laws.

Second, the Office of the Comptroller of the Currency and the Federal Home Loan Bank Board effectively should be dissolved. There's no point to them, other than giving out bank charters. There's no reason to regulate banks or financial services any differently than any other business. The antitrust laws should affect all businesses in the sense they affect competition.

But the major concern is with the insurance funds because now we've shifted all of the concerns to them. They are the ones who are going to bear the losses. Though I say they, I really mean the other banks and the general public bear the losses when some people in fact operate their banks badly.

What I would suggest, and here again I'll put an article in the record which goes into this in detail, is that the FDIC effectively be split into three insurance funds, not the other way around, not put it together with the FSLIC.

[The following material is supplied for the record:]

THE FUTURE OF AMERICAN FINANCIAL SERVICES INSTITUTIONS

THE SIXTY-FOURTH AMERICAN ASSEMBLY
APRIL 7–10, 1983

ARDEN HOUSE, HARRIMAN, NEW YORK

**The American Assembly
Columbia University**

The volume *Financial Services: The Changing Institutions and Government Policy* (editor, George J. Benston), containing the chapters described on the next page, will appear in public print in the fall of 1983 and may be ordered from the publisher: Prentice-Hall, Inc., Englewood Cliffs, NJ 07632. The telephone number is (201) 767-9520.

PREFACE

On April 7, 1983, 62 men and women representing the Congress, the executive branch, regulatory agencies, the full spectrum of the financial services industry, the law, the universities, and the communications media gathered at Arden House in Harriman, New York, for the Sixty-fourth American Assembly on *The Future of American Financial Services Institutions*. For three days, the participants discussed the goals and purposes of government supervision and regulation of financial services, the roles of various agencies in supervision and regulation, and the powers that the law should accord to various financial services institutions.

Professor George J. Benston of the University of Rochester acted as director for this Assembly program and supervised the preparation of papers which were used as background reading by the participants. Authors and titles of these papers, which will be compiled and published as a Prentice-Hall book to be entitled *Financial Services: The Changing Institutions and Government Policy*, are as follows:

Thomas F. Huertas	*An Historical Perspective on Current Issues*
George J. Benston	*The Regulation of Financial Services*
Paul M. Horvitz	*Payments System Developments and Public Policy*
George J. Kaufman Larry R. Mote Harvey Rosenblum	*The Future of Commercial Banks in the Financial Services Industry*
Robert Eisenbeis	*Bank Holding Companies and Public Policy*
Edward J. Kane	*The Role of Government in the Thrift Industry's Net-Worth Crisis*
Richard L. Peterson	*Consumer Finance*
Stuart I. Greenbaum Bryon Higgins	*Financial Innovation*
Almarin Phillips Donald P. Jacobs	*Reflections on the Hunt Commission*
George J. Benston	*A Summary of Public Policy Questions*

Speakers during the Assembly were Richard C. Breeden, director of the Task Force on Regulation; the Honorable Bevis Longstreth, Securities and Exchange Commissioner; and Senator Jake Garn, chairman of the Senate Committee on Banking, Housing, and Urban Affairs.

On April 10, following their discussions, the participants produced this report, which contains both assessments and recommendations. We gratefully acknowledge the contributions of Citicorp, the American Bankers Association, the U.S. League of Savings Institutions, Chase Manhattan Bank, the Bank of America, Beneficial Finance, Merrill Lynch, the Independent Bankers Association, the Securities Industry Association, CIGNA, Lehman Brothers Kuhn Loeb Inc., Chemical Bank, the "Temp Fund," and Marine Midland Bank, who helped sponsor this Assembly. They and The American Assembly, a national nonpartisan educational institution, have taken no stands on the subjects that were presented for public discussion. The participants spoke for themselves rather than for the institutions with which they are affiliated.

William H. Sullivan
President
The American Assembly

FINAL REPORT
# of the
SIXTY-FOURTH AMERICAN ASSEMBLY

At the close of their discussions the participants in the Sixty-fourth American Assembly, on *The Future of American Financial Services Institutions*, at Arden House, Harriman, New York, April 7-10, 1983, reviewed as a group the following statement. This statement represents general agreement; however, no one was asked to sign it. Furthermore, it should not be assumed that every participant subscribes to every recommendation.

PREAMBLE

The proposals contained in this report should be viewed as goals of public policy. The participants have not attempted to draft a legislative and regulatory program which, *in toto*, could or should be implemented immediately. Although it is important to initiate changes as soon as possible, it is obvious that a package of reforms of this magnitude will require time so that an orderly transition can be achieved.

* * *

Types of financial services and the way they are provided have changed considerably over the past several years. Even greater changes are likely to occur in the near future. Several factors are responsible for this development. Among the most important are a dramatically expanded demand for a diversity of financial services to meet changing customer needs and the increasingly competitive spirit among financial service suppliers fueled by high market interest rates and the increasing use of cost-reducing technology, which has lowered transactions costs and permitted new definitions of convenience other than proximity. These factors have resulted in an influx of new suppliers and changes in the operations of the present suppliers.

Historically, legislation encouraged, and depression-era legislation in particular furthered, a high degree of specialization in the provision of financial services—thrift institutions made mortgages and took in savings; commercial banks made commercial and consumer loans and mortgages, accepted demand deposits, took in savings, and provided fiduciary services; broker-dealers underwrote and brokered corporate and municipal securities and provided investment advice; insurance companies underwrote insurance and made mortgages and long-term investments in corporations; mutual funds offered pooled equity accounts; credit unions accepted savings and made consumer loans; finance companies, retail stores, and manufacturers advanced consumer credit. Each tended to offer separate and distinct products and services through different networks with individual salespeople dealing personally with customers. Interest payments were prohibited on transaction deposits and were limited by regulation on commercial bank savings deposits.

As market interest rates increased above the ceilings, enterprises not subject to the ceilings attracted customers' funds. Money market mutual funds grew rapidly. Brokerage firms developed money management accounts that have many of the characteristics of demand deposits except that they provide interest, and thrift institutions developed negotiable order of withdrawal (NOW) accounts. Thus, the distinctions among the institutions and the products offered increasingly blurred under the pressure of new suppliers, technology, and changed consumer demands. Now many financial services are sold by nationwide advertising and handled electronically.

Given these environmental and institutional changes, many restrictions designed for a different era are no longer serving their original purposes; indeed, in some cases they prevent financial institutions from serving the public as well as would be possible without them. It is time for these restrictive and inconsistent laws and regulations to be changed where appropriate, to eliminate those premised on purposes no longer applicable, and to update those premised on purposes that continue to be important. The changes we suggest are based on the following assessment of the goals of regulating financial services.

GOALS OF REGULATION

1. Both individuals and organizations must have access to an efficient and innovative supply of financial services to enhance domestic productivity and international competitiveness. This goal is best achieved by permitting full and vigorous competition among suppliers of financial services to achieve the broadest range of services at the lowest possible price.

2. The integrity and stability of the overall system of financial intermediation must be assured. While individual institutions may fail, the safety of deposits must be protected. Deposit insurance is an integral means of preventing losses to depositors and an impairment of public confidence in the financial system. Since deposit insurance shifts the cost of failures to the insurers and healthy institutions, the insurers have reason to be concerned with the way insured depository institutions are managed.

3. Preventing excessive concentrations of power within financial markets is a continuing objective. This can be accomplished by consistent enforcement of existing antitrust laws and ease of entry of new competitors.

4. Equitable treatment of consumers and financial institutions is another goal of regulation. Individuals should not be treated unfairly, and they should have access to competitive financial service suppliers and adequate information to make informed decisions among competing financial products. Measures to ensure fair treatment of customers should be cost-effective in their application, and suppliers of financial services should be regulated and taxed equitably.

Considering these goals, we make the following policy recommendations.

RECOMMENDATIONS

Entry Into the Market for and Limits on the Provision of Financial Services.

1. Institutions that accept governmentally insured deposits should not be able to provide directly, or through affiliates, services other than financial services and services closely related thereto. Conversely, institutions that provide nonfinancially related services or products,

directly or through affiliates, should not be able to own or control institutions that accept governmentally insured deposits.

2. There should be no restrictions on which other firms can offer financial services to the public, except for reasonable standards of capital, competency, and probity. A governmental or regulatory determination of "needs and convenience" should not be an entry-limiting consideration.

3. In particular, the restrictions requiring the separation of commercial banking and investment banking contained in the Glass-Steagall Act should be replaced with appropriate provisions addressing the problems of undue concentration of power and conflicts of interest in all financial services and for the fair and equitable access to all financial markets.

4. Interstate and intrastate branching and, except as required by Recommendation 1, holding company affiliation by depository institutions should not be restricted. These institutions should not be legally prohibited by federal or state laws from conducting business and establishing offices wherever the institutions believe there is public demand. (A minority of the participants disagreed with this recommendation.)

5. Governmentally insured institutions may invest in whatever assets they deem appropriate, including passive investments in debt and equities, subject only to reasonable regulation to protect the deposit insurance agencies.

Deposit Insurance

6. Government insurance, approved private insurance, or some combination thereof, should be required for demand transaction accounts that are not fully backed by liquid assets and for savings and time deposits. (A minority of the participants would not require deposit insurance.) Such insurance should cover each type of deposit up to an established level. The insurer should have the right to protect its interest by such means as examining and supervising the institution, requiring it to maintain a specified amount of capital, and being assured that it does not employ incompetent or dishonest managers. This supervision should extend to all related interests of the institutions to the extent necessary to protect the insurer from loss, and may include the requirement that specialized activities be

conducted in specialized subsidiaries. The supervisory authority should rest only in the insurer. The authority of the government agency would include the right to close the institution before the insured deposits were impaired, regardless of the source of the institution's charter.

7. Market-type disciplines should be made part of the deposit insurance system. The rate charged for deposit insurance preferably should vary with the risk imposed on the insurer. In addition, the federal insurer may require private coinsurance and/or additional capital as a means of reducing its risk.

Failures of and Mergers Among Financial Institutions

8. Like all other businesses, financial institutions should be permitted to fail. Depositors are protected by deposit insurance; the risk of failure should be borne by the shareholders, uninsured depositors, other creditors, and the managers of the institutions.

9. The antitrust laws should be applied to financial institutions as they are applied to other enterprises. Antitrust matters should not be within the province of the financial regulators.

10. There should be no restrictions on mergers among thrift institutions and commercial banks in their own or in other communities, within or across state lines, other than for considerations of antitrust and safety and soundness.

11. Depository institutions should be chartered, but not supervised, by federal and state authorities, as they now are. A choice among several chartering agencies is desirable from the standpoint of the public.

12. Supervision and regulation should be according to types of financial products or along other functional lines. For example, securities underwriting, as well as dealing and brokerage, should be subject to common statutes and a common regulator, as should money management and investment advisory activities, whether conducted in trust, agency, or pooled forms.

13. Regulation of diversified entities by the various regulators should be harmonized to reduce overlapping jurisdictions and the number of regulators to which any given institution is subject.

The Regulatory Role of the Federal Reserve

14. A comprehensive and efficient payment system can best be produced by competition between private entities and the Federal Reserve. The Federal Reserve's prices for these services should not be subsidized by its other activities.

15. Reserves may not be required for the conduct of monetary policy. However, if reserves continue to be mandatory, interest should be paid on them. With this reduction of an implicit tax, other aspects of the taxation of depository institutions should be reviewed to assure that the net effect on them is equitable with respect to other suppliers of similar services.

16. The Federal Reserve should not be directly involved in the supervision of depository institutions, except as necessary to protect its ability to conduct monetary policy and act as lender of last resort. (A minority of the participants believed that the Federal Reserve should not have *any* direct supervisory authority.)

Controls on Interest Rates Paid and Charged

17. There should be no ceilings or other restrictions on the interest rates or other terms of deposits. In particular, the prohibition of interest payments on corporate and individual demand deposits and Regulation Q restrictions on savings and time deposits should be repealed and rescinded.

18. Usury laws should be repealed. They restrict the availability of credit for all in times of high interest rates and to the less affluent in other times.

Disclosure and Consumer Protection

19. The provision of financial services in a deregulated environment requires sufficiently clear and adequate disclosure that allows all customers to make reasonable decisions.

20. The financial reports of institutions providing financial services should reflect their present financial conditions, taking into account yields, maturities, and asset qualities, so that an assessment can be made of the adequacy of their capital and the risk they present to the public.

21. All consumer protection legislation should be reviewed on a cost-benefit basis to ensure that it does not indirectly adversely affect consumers to a greater extent than it benefits them. Also, the government should regulate in this area by providing general rules, not by mandating detailed procedures. The government should encourage such processes as arbitration by which consumers may pursue adequate protection without recourse to litigation.

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The Assembly seeks to provide information, stimulate discussion, and evoke independent conclusions on matters of vital public interest.

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Deposit Insurance and Bank Failures

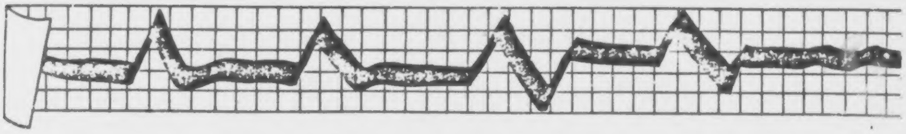
While a business failure is painful to those whose dreams and hard work are wiped out, most people recognize failure as a necessary aspect of success. This relationship is well summed up in the aphorism, "nothing ventured, nothing gained and nothing lost." Just as important is the healthy measure of restraint provided by the prospect of failure. The possibility and cost of failure can help avert unprofitable ventures and unfortunate errors by providing a powerful incentive for the decision maker to accept the necessity of making painful choices.

Why, then, is bank failure considered to be so terrible that federal deposit insurance is required? In many important respects, a bank failure is less costly than the failure of many other enterprises. The products provided by one bank are similar to those provided by many other institutions. Checking and savings account services usually are available at scores of institutions, including other banks, savings and loan associations, credit unions and stock brokerage firms—even non-local institutions. Mortgages and consumer loans are available from an even greater number of sources, including depository institutions, mortgage companies, consumer loan companies, merchants, and individuals. Business loans are available from local and, for larger companies, non-local banks and thrifts, insurance companies, factors, and other businesses.

While a bank's customers lose their business relationship with a bank and its knowledge of them, the loss is less than when most other suppliers fail. For example, the failure of a machinery manufacturer could make spare parts, repair and replacement services unavailable. A distributor's failure might require the development of new channels of supply and sources of information about products and reliability. Often the failed enterprise is unique. In contrast, one bank and its products are very much like another. Only for people in one-bank towns might the failure of the sole bank present a serious problem—and then only until the services are offered by another institution.

Because banks are so similar, their employees' skills are transferrable to other financial institutions. The teller in one bank needs little training to work in another. A lending officer can even benefit from a failure if she can bring her customers with her to another bank. In contrast, employees of many other enterprises often have specialized skills of little value except to their company. The only bank employees who really lose from a failure are the top officers. Not only might they be blamed for the bank's collapse,

With bank troubles again in the news, deposit insurance is receiving its closest scrutiny since the Depression years. This analysis questions whether a new approach to insuring deposits might be in order—with depository institutions able to choose between several public insuring agencies or even turning to private insuring organizations.



but they will forego the value of the relationships they have established. But, if fear of failure is to be beneficial, this is all to the good.

The shareholders of a failed bank, like its officers, bear costs. But, again, this can prove healthy, for the essence of a private-property, free-enterprise system is that residual owners reap the losses as well as the benefits from their investments. In any event, bank shareholders are in no different position from shareholders of other enterprises. Indeed, when one considers that a bank's fixed assets can be transferred to many other enterprises (including successor banks) at less cost than can the assets of many failed enterprises, a bank's owners face less risk with respect to a failure than most other owners.[1]

This leaves only the creditors, and here is where banks differ importantly from other enterprises. But first the similarities should be mentioned. Creditors are investors with rights over other investors. Debt instruments usually specify the amounts to be paid and the time of payment to their holders, with precedent over the equity holders. But, as with equity holders, creditors accept the risk of non-repayment, which is reflected in their contracts (debt obligations) with the equity holders. Debt holders, like other investors, put up their funds and take their chances. The possibility of failure gives them reason to monitor an enterprise's activities and to insist on a return no worse than they could get for similarly risky investments. In this regard, a bank is a safer investment than many others because its activities are relatively easy to control and comprehend and are subjected to audit. Indeed, losses to creditors (depositors) were not great before the Great Depression. Between 1900 and 1920, deposits in the 1,789 banks that suspended operations averaged 0.10 percent of total deposits each year. Over the 1921-1929 period, 5,712 banks were suspended (an annual percentage of 2.30 of the number active); deposits in these banks averaged 0.42 percent of total deposits per year. But, after the affairs of the suspended banks were cleared up, the annual losses borne by depositors as a group were only 0.15 percent (Benston (1973), Table II, p. 12).

The Difference Between Banks and Other Enterprises

The important difference is in the demand deposits form of credit. Demand deposits and savings deposits that actually can be withdrawn on demand are much more than investments in banks. These are assets that permit depositors to effect transactions at relatively low cost while providing a means of making investments in the amounts and for the periods desired. Because deposits and withdrawals tend to offset each other, bankers learned hundreds of years ago that they could invest a large proportion of these funds in longer maturity, usually higher yielding assets. This combination of instant possible withdrawal for individual depositors and relative stability of the total of funds invested by depositors as a group gives rise to both profitability and risk in banking.

Unlike bank demand depositors, creditors of other enterprises cannot withdraw their investments when they wish. If a bondholder of an ordinary corporation believes the corporation may be unable to repay the debt as promised, the most that person can do is sell the bond before the purchaser learns the bad news. The bondholder cannot get the corporation to repay the bond until it is legally due. But a depositor who fears a bank failure can withdraw funds in person or by writing a check. A rapid withdrawal of funds by depositors may force the bank to sell assets at distress prices or to borrow at high rates. That may produce losses that exceed the stockholders' investment and have to be absorbed by remaining depositors or other debt holders. Therefore, depositors are well-advised to remove their funds if the probability of loss exceeds the cost of making another banking arrangement plus interest that would be foregone as a consequence of the withdrawal. That is why a run on

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[1] See Tussig (1967) for a further discussion.

"A rapid withdrawal of funds by depositors...may produce losses that...have to be absorbed by remaining depositors or other debt holders.... That is why a run on a bank...is very difficult to stop...."

a bank by panicked depositors is very difficult to stop before the bank is forced to suspend withdrawals and possibly fail.

Were it not for three factors, losses from bank runs should not be considered of greater social concern than losses from other business failures. The first factor is the importance of public faith in a safe system for transferring funds. If people feared bank failures, the argument goes, they would be unwilling to accept checks in payment for goods and services, which would increase transactions costs to the detriment of society. But checks are widely and readily accepted despite the risk that the payor may not have funds on deposit when the check is presented to the bank for payment. Though a bank failure represented an additional risk, checks were widely and increasingly used as money before the advent of federal deposit insurance, even in the 1920s when over 600 banks a year suspended operations. Prior to establishment of the Federal Reserve in 1913, notes issued by individual banks were widely used as money, despite the risk that the issuing banks could fail before the notes were redeemed. Consequently, this is not a convincing argument for having a different public policy towards bank failures than towards other business failures.

The second argument for special treatment of banks relates to the depositors' costs of determining and dealing with the riskiness of their investments. Bank deposits, particularly demand deposits, often cannot be diversified efficiently among several banks. If this could be done, depositors could reduce their risk of the expected losses from bank failures generally (which was only 0.15 percent per year even during the 1920s). But such diversification would be costly to many depositors. Rather than having each depositor assessing and monitoring the operations of banks and the riskiness of their portfolios, it seems more cost-effective for a government agency to supervise the banks. But the same argument applies to many (perhaps most) other enterprises. Investors in these enterprises also must assess the risks and returns expected from their investments; in this regard, banks are likely to be easier to analyze than are other firms. But where small deposits are involved, the depositors' costs in assessing and diversifying risk probably exceed expected benefits. Therefore, social policy could be directed toward making riskless investments and depository services available to people with relatively little to invest. But this protection could be provided by bank-purchased private insurance, rather than a government agency, much as other enterprises and individuals insure their customers and themselves against risks.

Bank Runs

The third argument, preventing multiple bank runs, is the only really strong one for considering bank deposits differently from other investments and services. Demand depositors have a great incentive to remove their funds as soon as they believe a bank **might** fail. Hence, rumors about a bank's financial condition or the failure of similar banks might touch off runs on well-managed banks. Their failures, in turn, reduce the monetary base as people exchange fractional-reserve bank deposits for 100 percent reserve currency, resulting in a multiple contraction of the money supply and the failure of more banks and other businesses. This is what happened, in part, in the 1930s.[2]

While the Federal Reserve can step in to stop this chain-reaction by making reserves available to banks to replace those withdrawn, it did not do so in the 1930s. Between 1930 and 1933, 9,096 commercial banks were suspended, representing an annual average of 11.3 percent of all banks and 4.1 percent of the deposits. The average annual loss to depositors in these banks averaged 0.81 percent. While this was less than a third of the yield on investments (the yield on prime commercial papers ranged from 3.59 percent in 1930 to 1.73 percent in 1933), it probably

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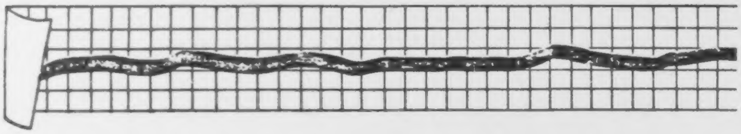
[1] The Federal Reserve's present policy of reserve-path targeting, however, makes it likely that reserves would not be permitted to decline as they did in the 1930s. Indeed, it makes intervention automatic.

[2] Though these failures no doubt hurt the economy, most scholars agree the banks were primarily the victims rather than the cause of the Great Depression. Warburton (1966) carefully studied the relationship between bank failures by county during the Depression. He concludes: "there was a



was large for affected depositors who did not hold diversified portfolios.[3]

Bank runs also played an important role in previous financial collapses before the 1930s. "Black Thursday" 1873 saw the failure of Jay Cooke's banking house and the first closing of the New York Stock Exchange. It was followed (perhaps causally) by six years of depression. The failure in 1884 of the Marine National Bank and of former President Ulysses Grant's firm, Grant & Ward, sparked runs and the consequent failure of numerous banks and brokerage houses. The Panic of 1893 was touched off by the 1890 failure of the London banking firm of Baring Brothers, which specialized in financing U.S. enterprises. Baring's European creditors demanded that Americans pay their debts in gold. As a consequence, the base money supply was depleted, a multiple contraction resulted, and 1891 saw a mini-panic. During the following 1893 panic, more than 600 banks and 13 of every 1,000 businesses failed in perhaps the nation's second deepest depression (after the depression of 1837) before 1930. The New York Clearing House suspended convertibility to specie, which ended the run. J. P. Morgan also helped by negotiating a sale in Europe of a $100 million U.S. bond issue. Panic struck again in 1907 when New York City and several corporations were unable to sell high-yielding bond issues. The Knickerbocker Trust Company failed (largely as a consequence of speculation with depositors' funds) and several major banks experienced severe runs. Again, the New York Clearing House suspended convertibility to specie and J. P. Morgan later helped increase reserves with European loans and U.S. Treasury deposits.

Creation of the Federal Reserve in 1913 was supposed to rid the country of these recurring collapses. As the lender of last resort, with great resources and the power of the printing press, it should have been able to better the Clearing House's and Morgan's record. But, when the Bank of the United States collapsed in 1930, the Fed did not prevent the failure of over a third of the banks during the next several years. Establishment of the Federal Deposit Insurance Corporation (FDIC) in 1933, though, appears to have done the job. Though 488 commercial and mutual savings banks were suspended from 1934 through 1942, most of these were leftovers from the pre-FDIC period. From 1943 through 1982, an average of only seven banks a year were closed or merged with FDIC assistance. Most importantly, bank runs appear to be a thing of the past. However, the losses incurred by large depositors when the Penn Square Bank in Oklahoma City was liquidated rather than merged into a solvent bank by the FDIC and the reported shaky condition of some very large banks with loans extended to such borrowers as Brazil, Mexico or International Harvester have provoked some concern about the possibility of runs by uninsured depositors.

Depositors in savings and loan associations, credit unions and a few mutual savings banks also are protected by government insurance agencies—the Federal Savings and Loan Insurance Corporation (FSLIC) and the National Credit Union Share Insurance Fund (NCUSIF). In recent years, unexpectedly increasing interest rates together with the specialization of savings and loans in long-term, fixed-interest assets (mortgages) have resulted in a relatively large number of failures and forced mergers. The increasing number of "troubled institutions" has renewed interest in the present deposit insurance system. This interest is expressed in the Garn-St Germain Depository Institutions Act of 1982, which calls for a study of deposit insurance and a report to the Congress by this April.

The Benefits From Deposit Insurance

Deposit insurance has the salutary effect of obviating bank runs by assuring insured depositors

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massive contraction of deposits nationally during the early 1930s relative to the rate of growth during the 1920s, of which less than one-fourth was accounted for by deposits in suspended banks. This indicated that the Depression of the 1930s could not be explained by the impact of balances of payment resulting from adverse conditions in particular industries or areas, but was due to, or at least associated with, some potent force operating on a national scale." (p. 2).

"Deposit insurance...gives bankers an incentive to put the depositors' funds into riskier assets [than they otherwise would]."

(currently, those with less than $100,000 in an account) that their funds are safe. It also spares most depositors the cost of learning about the operation of banks. But, as a consequence, deposit insurance frees banks from the discipline and cost of those depositors' concerns. Bankers need not pay depositors a premium (in interest, "free" services, or other concessions) to compensate them for the risk of investing in the bank. Thus bank profits are increased if the reduction in their cost of deposits is greater than the cost of the deposit insurance. Such is the case for smaller banks, and was particularly so in the 1930s when the FDIC was established. Initially, FDIC insurance covered depositor accounts up to $2,500. It was raised to $5,000 in 1934, $10,000 in 1950, $15,000 in 1966, $20,000 in 1969, $40,000 in 1974 and $100,000 in 1980.

Federal insurance thus covered most of the depositors (and deposits) of small banks. It was particularly valuable to them because the public had reason to fear for the safety of their funds in small banks; 93 percent of the banks suspended in 1930-1931 had total loans and investments under $2 million, and 70 percent were under $500,000. From the beginning, the FDIC insurance premium has been assessed as a small percentage of total deposits, whether or not insured. Thus the large banks, which experienced much lower failure rates and which served many customers with deposit accounts exceeding $5,000 in the 1930s, have subsidized the small banks. But in return they benefited from banking legislation through the prohibition of interest on demand deposits. Golembe has estimated that in the early 1930s, the costs of deposit insurance to the large banks were offset almost exactly by savings from the interest prohibition (Golembe, 1975, p. 7). The small banks also avoided competition because national banks were denied the right to branch (except as permitted by state law).[4]

Savings and loan associations did not experience the massive number of suspensions that plagued commercial banks in the early 1930s; only 526 of the S&Ls active as of January 1930 (4.4 percent) were suspended from 1930 through 1933. The FSLIC was established by the National Housing Act of 1934 as a means of supporting the housing industry. That purpose dominated government policy towards S&Ls until, perhaps, the last few years when the institutions' survival became an important concern.

Problems With Deposit Insurance

If deposit insurance removes the concern of most depositors for the safety of their funds, it gives bankers an incentive to put the depositors' funds into riskier assets unless the FDIC or FSLIC prevents them from doing so. If a bank encounters trouble, the FDIC and FSLIC pay off the depositors; if profits are made, the shareholders get them. True, in the event of failure the bank's shareholders lose their investments (including the value of the bank charter) first. But they can lose no more. Consequently, unless the FDIC or FSLIC imposes a risk-related insurance premium, an effective minimum capital (stockholders' investment) requirement or other risk-related costs and controls, the banks' expected gains from additional risk-taking will continue to exceed the expected losses.[5]

U. S. history prior to the FDIC bears this out and also provides lessons that should be heeded. Deposit guarantee systems were established in New York (1828), Vermont (1831), Indiana (1834), Ohio (1845) and Iowa (1858).[6] The New York and Vermont systems were state run, the others

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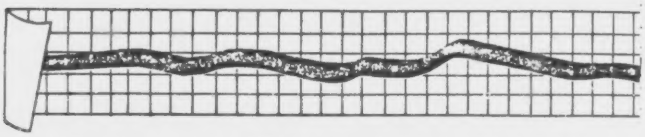
[4] See Benston (1982) for a description of the offsetting economic advantages garnered by suppliers of financial services from 1930s federal legislation.

[5] This conclusion is demonstrated analytically and rigorously in a number of papers, including Sharpe (1978), Koehn and Santonero (1980) and Hanweck (1982). Also see Flannery (1982) for a clear and concise explication and numerical example.

[6] See Federal Deposit Insurance Corporation (1952, 1953 and 1956) and Edwards (1933) for descriptions from which the following narrative was drawn.

[7] However, it should be noted that the New York State system was phased out as bank charters were granted and renewed under the free (entry) banking law. As banks left the insurance system, the premiums rose considerably.



were based on mutual agreements among participating banks. They operated successfully, largely because they empowered system officials to monitor operations of the participating banks and to control excessive risk-taking.[7] Yet a second wave of deposit guarantee plans for state banks proved less successful. With one exception (Mississippi), the plans did not include effective supervision and they failed. These included the compulsory plans of Oklahoma (1908), Nebraska (1909), and South Dakota (1916) and the voluntary plans of Kansas (1909), Texas (1910), and Washington (1917). Since depositors were told that their money was safe, there was a great incentive for unscrupulous operators to take excessive risks; the record shows greater failure rates of guaranteeed banks than among similar non-guaranteed banks operating in the same areas. The Mississippi plan (1915), which included supervision and bank examinations, continued until 1930. Thus, effective supervision appears to be a necessary aspect of deposit insurance.

FSLIC deposit insurance appears to be intentionally related to risk-taking by insured savings and loan associations. Though technically the mutual associations' liabilities are shares, in actuality they are (except for time certificates) deposits withdrawable on demand by the "shareholders." Hence, were S&L deposits not insured, depositors would have reason to be concerned about the associations' concentration in long-term, local, fixed-interest mortgages. Should the market value of real estate securing the mortgages collapse, or should interest rates unexpectedly surge, the market value of an association's assets could be reduced to less than its liabilities. Fearful depositors would have the same incentive to remove their funds as would depositors in commercial banks. Thus FSLIC insurance prevents runs on S&Ls and permits them to hold a poorly diversified portfolio, consisting mainly of mortgages.[8]

Past and Present Methods of Coping with the Problems

Restrictions on Entry and Encouragement of Mergers

The FDIC and the other regulatory agencies initially dealt with the problem of bank failures by restricting bank charters. In the 1920s, an average of 361 banks a year was chartered. But from 1935 through 1944, an average of only 53 banks was chartered annually. Understandably, few banks were chartered during World War II. But the expansionary period of 1945 through 1959 saw an annual average of only 94 newly chartered banks. Peltzman (1963, p. 48) estimated that, had the relatively unrepressed chartering policies of the 1920s continued during the 1936 through 1962 period, about 4,500 new banks would have been chartered rather than the 2,272 that were permitted. Partly as a consequence of this restrictive policy, very few banks failed, but fewer banks were established to serve the public.

Not until James Saxon became Comptroller of the Currency was this policy changed. In just four years, 1962 through 1965, he approved charters for 514 national banks, twice the number chartered in the previous 12 years. Contrary to the predictions of Saxon's detractors, neither the newly chartered banks nor their competitors failed in greater proportions than other banks. States also increased the number of bank charters issued to 124 per year over the 1962-65 period—an increase from the annual average of 86 over the previous four years. Though there have been relatively more bank failures in recent years, the number is still small and appears unrelated to the more liberal post-1960s chartering policy.

The regulatory authorities also have encouraged mergers among banks as a means of reducing the probability of failure. Until the Bank Merger Act of 1960 required the regulatory agencies and

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[8] Federal authorities also have supported S&Ls' concentration in mortgages by imposing ceilings on deposit interest by giving them greatly reduced taxes based on their investment in mortgages, by developing a national market in mortgages with the Federal Home Loan Mortgage Corporation and by establishing Federal Home Loan Banks that lend money to S&Ls raised with government-guaranteed securities.

"[Under previous constraints] the risks banks undertook were relatively easy to monitor and control. [Under deregulation] the possibility that greater risks will result in more failures must be considered...."

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encouraged the Justice Department to evaluate and challenge mergers, their impact on competition was not considered important; safety was the primary concern.

State-enacted legal restrictions on branching have had a negative effect on bank solvency. Almost all of the banks suspended in the 1920s and 1930s were unit banks: only 10 banks with more than two branches outside their home city failed during this period. It is difficult to separate the effects of regional economic depressions and small size from unit banking as causes of the suspension of over 9,000 such banks. Still, it seems clear that the legal prohibition against banks diversifying their locations—and consequently their assets and liabilities—impaired their ability to survive liquidity or local economic crises.

In any event, reducing the number of banks—and thus competition among banks—by controlling entry and encouraging mergers is no longer a viable policy, and not just because of cost to the public. Many unchartered enterprises now offer banking services to the public: these include brokerage firms, money market funds, and specialized lenders including mortgage companies, finance companies, retail stores, factors, and insurance companies. While interstate deposit branching still is prohibited, most large banks maintain loan and customer service offices in cities around the country, as well as affiliates that specialize in such products as mortgage and personal cash loans. Smaller banks can diversify their portfolios by purchasing loans from other banks and by investing in money market instruments, such as U.S. Treasury and state and municipal obligations. Thus, reducing bank failures by controlling entry and exit appears to be neither necessary nor even possible.

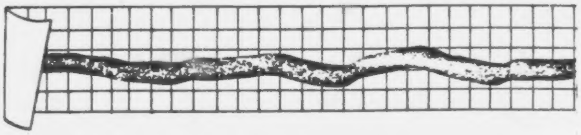
The opposite policy has been applied to federal savings and loan associations, with new federal S&Ls encouraged as a means of supporting housing. Between 1933 and 1941, the number of federally chartered associations increased by 162 a year. During World War II, few federal charters were granted. But from 1946 through 1970, federally chartered S&Ls increased by 25 annually.

The recent financial problems of many S&Ls, though, do not appear attributable to excessive chartering. Rather, they are related to traditional restrictions on the portfolios they could hold and services they could offer to the public. The thrift institutions' solvency was never in doubt as long as real estate values increased, interest rates did not surge unexpectedly, and interest rate ceilings on deposits were effective in keeping their costs down but not in encouraging excessive disintermediation. The provisions of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Act of 1982, which permitted thrift institutions to offer most banking services and market rates of interest, came too late for many institutions to diversify their assets and liabilities successfully.

The Federal Home Loan Bank Board's policy change since the late 1970s that removed constraints on branching by federally-chartered S&Ls permitted the institutions to serve the public more effectively. Yet it was timed unfortunately from the standpoint of maintaining solvency. Branching is a means of offering depositors a return on their funds in the form of convenience. But it is often more efficient to offer them direct cash payments through interest and a wider range of services (especially checking and consumer loans). Hence, since the S&Ls can now offer these services to consumers, many branches established earlier are likely to have become financial drains on the associations. Thus, incomplete deregulation inadvertently exacerbated the S&Ls' solvency problems.

Restrictions on Products and Prices

The debacle of the 1930s gave rise to the Banking Act of 1933. This act prohibited commercial banks from underwriting and dealing in corporate securities, prohibited the payment of interest on demand deposits, and imposed a ceiling on savings and time deposits interest rates (Regulation Q). Banks and thrift institutions also were constrained over the years from competing directly and from engaging in non-traditional banking activities. One consequence of these constraints was that the risks banks undertook



were relatively easy to monitor and control. Another was that, in the 1970s, as nominal interest rates increased and as fund transfer technologies became more efficient, unregulated institutions successfully bid for many of the regulated institutions' depositors. Banks and thrifts also attempted to enter new areas through subsidiaries, one-bank holding company affiliates, and legal expansion of powers. While the result has been greater returns and more choice for consumers, the risks undertaken by depository institutions also are likely to have increased. Nevertheless, re-regulation hardly seems possible or desirable. The possibility that the greater risks will result in more failures, then, must be considered and dealt with.

Equity (Capital) Requirements

Since the stockholders of a bank or S&L absorb losses first, a sufficiently high equity investment would inhibit them strongly from taking risks. Indeed, as long as a deposit insuring agency can step in and liquidate an institution by merger or dissolution before the value of its assets declines to less than its insured deposits, the agency assumes no risk. (Fraud, of course, can create the deceptive appearance of positive equity; therefore audits, for fraud are particularly important.) Consequently, the supervising authorities have viewed capital adequacy requirements as a means of reducing the possibility of failures.

However, the authorities' effectiveness in enforcing edicts is open to question. Mayne (1972) studied 364 randomly sampled Fourth Federal Reserve District banks to determine whether the supervisory agencies had asked them to provide additional capital over the period 1961-1968. Of the 73 percent that replied, 30 percent (81 banks) said that these requests were made, some repeatedly. But of these, only 43 percent fully complied with the authorities' requests, 27 percent partially complied, and 30 percent did not comply at all. Mayne concluded: "The agencies do differ in their capital prescriptions, but ... these prescriptions have only a limited effect on bank capital positions because of banker resistance to supervisory pressure for more capital" (p. 47). Peltzman (1970, p. 16), who analyzed statewide aggregate data, also found that banks do not "respond to any of the regulators' standards of capital adequacy." But Mingo (1975), who used more recent individual bank data, reports that banks given lower examiner ratings subsequently tend to increase their capital.

These divergent findings may be due to the different periods or samples studied. They also may be the result of uncertainty about how much capital is adequate. Not only are the accounting numbers used to measure capital inadequate estimates of economic values, but there is reason to believe that a balance sheet ratio is not a sufficient indicator of risk.[9] Indeed, an extensive review by Lyon (1969, p. 31) led her to conclude that "the literature is voluminous but consists primarily of the prevailing opinion at any given time stated as a fact by its proponents, without benefit of analytical analysis."

In any event, the data indicate that the ratio of book capital to deposits of smaller (under $100 million in assets) banks has increased 10 percent over the 1970s from 7.6 percent in 1970 to 8.5 percent in 1980. Assuming that these accounting-based numbers reflect economic values consistently over the time period, this increase could have been the result of pressures by the regulatory authorities. Or the banks voluntarily could have increased equity relative to deposits, perhaps because the stockholders (who often are bank officers or relatives) wanted to reduce their personal income taxes by not paying dividends or officers' salaries. However, the equity/deposits percentage for very large (over $5 billion in assets) banks decreased by 13 percent over the 1970s, from 5.3 percent to 4.1 percent.

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[9] See Vojta (1973), who argues that the present and future expected profitability of a bank should be taken into account. While several studies found lower capital ratios at banks that failed compared to solvent banks of similar sizes, it is unclear whether impending failures reduced their capital or whether low capital resulted in their failures. (See Cotter (1966) for a study of West Coast banks that failed between 1921 and 1933, and Benston (1975) for an analysis of banks that failed between 1959 and 1971.)

"Examinations constitute a principal means of reducing failures of banks and thrift institutions."

(Over the complete range of bank sizes, the larger banks tended to have lower ratios and, over time, those ratios decreased more for the larger banks.) Again assuming that these numbers are meaningful, it would appear that the authorities have less ability to control the capital investments of large banks. One reason is suggested below.

Until about 1980, when the S&L capital problem became overwhelming, the FHLBB had somewhat greater influence in getting thrifts to maintain their book capital, primarily because many associations' capital/deposit ratios became so low that they feared cancellation of FSLIC insurance. Edward Kane (1981) points out that FSLIC insurance represents a valuable asset to most associations, since it is priced below what would be the market rate. Mutual associations, as a practical matter, cannot raise equity capital except in the form of retained earnings. Hence, Kane shows, "insur[illegible] net worth from falling bel[illegible] required to stay eligible for FSLIC insurance...by not realizing capital losses on their mortgage portfolios" (p. 90), even though this would have reduced their tax liability.

Field Examinations and Supervision

Examinations constitute a principal means of reducing failures of banks and thrift institutions. National banks are examined by the Office of the Comptroller of the Currency at least twice every three years. State-chartered Federal Reserve member banks are examined by the Fed at least once a year, and other state-chartered FDIC-insured banks are examined by the FDIC and often also by state banking departments at least once a year. The Federal Home Loan Bank Board examines FSLIC-insured S&Ls annually. State-chartered S&Ls also are examined by some state banking departments.

The examiners look at the documentation and collateral for most large loans and a sample of small loans and they check the institutions' compliance with federal and state laws. Loans are classified into loss, doubtful and substandard categories. The institutions' managers and management procedures and policies also are evaluated. If an institution is found wanting, it is characterized as a "problem" or "serious problem" and subjected to closer scrutiny and more frequent examinations.

Although it seems clear that examinations of some sort are a necessary aspect of deposit insurance (given its built-in incentive towards risk-taking), there is reason to question the usefulness of examinations for preventing many failures. The examiners' ability to uncover serious problems of fraud and insider dealings appears to be far from perfect, judging from FDIC reports and published research. Among the 56 bank failures that occurred between January 1959 and April 1971, fully 59 percent were rated as "no problem" at the examination just prior to their failures.[10] The principal reasons given for the 56 failures are: fraud and irregularities, 66 percent; brokered funds and loan losses, 27 percent; and inept management, 7 percent.[11]

A more recent study by Sinkey (1977) uses a different set of classifications but draws similar conclusions. He finds that, of 84 failures between 1960 and mid-1976, some 54 percent resulted from improper insider loans or out-of-territory loans involving brokered funds, 30 percent from embezzlement or manipulation, and 17 percent from managerial weakness in loan administration (p. 27). In an earlier failure study by the FDIC, Hill (1975) found similar proportions. It cannot be ascertained, however, whether this record is close to the best possible, in the sense that the cost of preventing more failures would have exceeded the benefit. Also, the more recent record has not been studied.

The effectiveness of the FSLIC's examiners has been studied only with respect to the relatively large number of S&Ls in Illinois that required the FSLIC's financial assistance from 1963 through 1968. These 19 losses represent 75 percent of the total losses suffered by the FSLIC over the period. Bartell (1969, p. 353), stated that he

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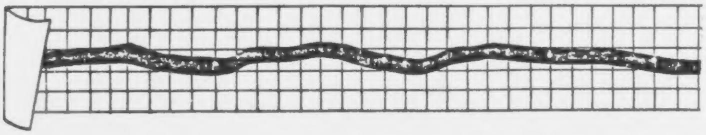
[10] Benston (1975), Table XIII, p. 43.
[11] Benston (1975), Table XI, Table XI, p. 40.



identified nine associations where failure could be attributed primarily to management deficiencies or errors of judgment. In these cases the management apparently believed that the actions which later caused failure were taken in the best interests of the association and its savers. In the second category were 10 associations where fraud, influence, defalcation, or some other criminal intent was the principal cause of failure. In all of these cases, one or more of the officers, directors, and/or major stockholders was indicted for misapplying association funds, and in most cases convictions have been obtained.

With respect to the examinations, Bartell concludes that they were well done; if anything, they were too thorough (p. 418). But, he states, "In contrast with the generally high quality of examinations, supervisory performance in the handling of failed associations leaves much to be desired" (p. 419).

Supervision of financial institutions is functionally related to, though not necessarily dependent on, field examination. To a limited extent the supervisors can specify the portfolios of assets and the nature of the liabilities that insured financial institutions can hold. Supervisors enforce a limitation on loans to any one borrower and they restrict loans to officers, directors and shareholders. They can also restrict the types of loans and investments that can be made. Field examinations to ensure that the regulations are observed would appear to be necessary, particularly where activities conducted at less than arm's length can occur. But the supervisors also can use statistical models and computers to analyze data reported by the institutions for signs of possible problems. Such systems have been used by every federal agency and several state agencies since the mid-1970s.[12] But, as Flannery and Guttentag (1980) conclude from their analysis of the early warning systems, these systems have not been validated; hence, we do not know how well or even whether they are effective for predicting failure. In fact, the systems appear to be used primarily as a more efficient means for the examiners to look at and structure data for their reports.

The supervisory authorities also must decide when to require an institution to discontinue a criticized practice (such as acquiring brokered deposits or making high-risk loans), dismiss an inept or possibly dishonest officer, obtain more capital from shareholders, terminate insurance,[13] or close or arrange for a merger with another institution. Before the Financial Institutions Supervisory Act of 1966 gave federal supervisors authority to issue cease-and-desist orders, the principal legal sanctions available were cancellation of insurance and seizure of an institution for liquidation or reorganization. Since 1942, the principal procedure used to handle failing banks has been a sale of the bank to an institution that assumes liability for both insured and non-insured deposits.[14] Payoffs limited to insured depositors generally have involved only small institutions located in unit banking states that do not permit another bank to acquire and operate the failed institution as a branch. Recently, in the case of Oklahoma's Penn Square Bank, the poor and questionable condition of the bank's assets precluded its sale. Because they are government agencies, the FDIC, FSLIC, and NCUIF have the power to close an institution before the market value of its assets is less than its insured deposits, which can prevent losses to the insuring agencies except in cases involving rapid deterioration or fraud. But they may also be subjected to political pressure and to the reluctance of a supervisory agency to admit that one of "its" institutions has to be closed.[15]

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[12] See paper on "Early Warning Systems for Problem Financial Institutions," in Altman and Sametz (1977, pp. 3-68) and Flannery and Guttentag (1980) for descriptions and critiques of these systems.

[13] If insurance is terminated, the institution's existing accounts continue to be insured for two years.

[14] See Barnett, Horvitz, and Silverberg 1977, pp. 306-317 for a good discussion of the advantages and disadvantages of the alternative procedures.

[15] Bartell (1969, pp. 419-421) documents the effect of prior congressional criticism of S&L closures on the reluctance of the FHLBB to follow the recommendations of its examiners expeditiously.

"[Since restrictions on entry also reduce competition and service], restricting entry to reduce failures, even if it were desirable, is no longer feasible."

Some critics have argued that divided authority among regulators also has reduced the effectiveness of supervision. While the FDIC and FSLIC have responsibility for insuring the deposits of state-chartered institutions, only the state authorities have the power to close the institutions. (Bartell reports that this was an important problem for the FSLIC with respect to the failing Illinois associations.) Holding companies are regulated by the Federal Reserve but their affiliated banks are chartered by the states and/or the Comptroller of the Currency. Shull (1980) finds in his analysis of holding company failures that, "the extent of actual conflict among federal banking agencies in holding company supervision, while difficult to quantify, is important, time consuming, and diverting in problem cases" (Vol I, p. 119).

A Changing Environment for Deposit Insurance

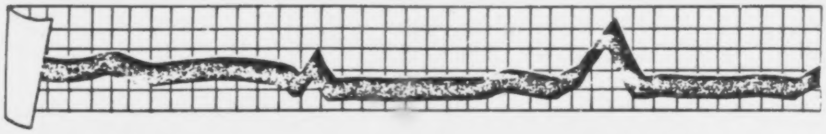
Restrictions on entry and the encouragement of mergers have been effective in reducing failures, but at the cost of reduced competition and, therefore, less service to consumers and fewer opportunities for potential bankers. In any event, changes in technology, fueled by inflation-induced high nominal interest rates, have encouraged other, non-regulated suppliers of financial services to enter the market. Their entry no longer can be restricted. Hence, restricting entry to reduce failures, even if it were desirable, is no longer feasible.

Capital adequacy requirements are desirable. But, to be effective, they must be tailored to the asset portfolio and deposit distribution of each institution. If too much equity is required, insured depository institutions will be disadvantaged and resources allocated inefficiently. If too little capital is required, institutions will be encouraged to take greater risks and the costs to the insurance agency are likely to exceed the fees it levies. Furthermore, capital adequacy is a very blunt requirement. It is expensive for financial institutions to raise capital (in addition to retained earnings) in relatively small amounts. Closely held, usually smaller institutions, are likely to find floating equity quite difficult. Majority shareholders may lack the resources or may not wish to concentrate their wealth further, and outside investors frequently are unwilling to take minority positions except at a considerable discount. Mutual institutions also might find it expensive to market debentures.

Deposit insurance rates that vary with the riskiness of an institution's assets and liabilities have been suggested for years as a preferable means of dealing with the problem. However, the deposit insurance agencies still charge the same percentage to all institutions, partly because it is difficult to set variable premiums. (Indeed, none of those recommending this change have specified how the premiums should be determined.) But the same information is required for an equity requirement. Another reason for the resistance to change is that regulatory agencies believe the present system of field examinations and equity requirements, roughly determined and enforced though they may be, are adequate.

Finally, the present system may be politically desirable, balancing smaller institutions' benefits from having the premiums applied to all (including uninsured) deposits against large banks' benefits from an incomplete control of the risks they take. The residual risk ostensibly is borne by the deposit insurance agencies. But since the government is expected to stand behind the agencies, the general public is accepting the residual risk.

Field examinations have two major shortcomings. One is that they are expensive. Teams of examiners spend days to weeks at each bank, going over records in considerable detail. Not only do the insurance agencies and the institutions they charge for these services incur considerable costs, but the institutions bear such costs as disrupted operations and the expense of preparing and presenting requested data. The second shortcoming is the difficulty of prompt detection of problems precipitated by fraud or changes in an institution's economic environment. These are difficult to detect through periodic inspections of an institution's loan portfolio, management systems, and regulatory compliance.



A related problem involves our system of regulation. Supervisors may not be able to control potential problem banks as well when the banks are regulated by several agencies as when they are regulated by a single agency. For many commercial banks, especially the large ones, the chartering agencies (the Comptroller or the states) and the Federal Reserve have regulatory responsibility as well as the FDIC. This divided authority may permit some banks to take greater risks than an insurance agency acting alone would have permitted. But then, the temptation for an insurance agency to reduce risk at the expense of innovation must be recognized.

Proposed Solutions

My analysis has concluded that mandatory deposit insurance is justified because deposits that are withdrawable on demand create the possibility of bank runs, which can visit considerable costs upon banks, their customers and others. The government has been charged with insuring deposits in part as a response to Depression-era political pressures by small banks, the home building industry and some depositors, and in part because the government has the power to enforce its orders on banks and cannot, itself, go bankrupt. Another reason for government intervention in insurance is that the government's control over bank reserves gives it the power to cause and the power to prevent massive numbers of bank failures.

The basic problem with government-provided mandatory deposit insurance is that it provides the insured institutions an incentive to take excessive risks. Consequently, the institutions must be examined and supervised. But there is danger that this process is conducted less efficiently and effectively because the responsible agencies are monopoly suppliers of the insurance to each group of institutions.

The following changes in current procedures, I believe, would help reduce the costs of achieving the benefits from mandatory deposit insurance.[16]

1. All deposits withdrawable on demand, such as checking accounts, NOW accounts, money market deposit accounts, and passbook savings accounts, should be insured by a responsible insurer. The only exceptions would occur where deposited funds are invested in assets that have almost no probability of being worth less than the deposit liability (such as money market funds that are invested in a well-diversified portfolio of short-term government obligations or bank certificates of deposit). All demand-type deposits should be insured for two reasons. One is that runs on uninsured balances can force bank failures or a massive infusion of resources by the authorities to prevent a failure (as was done for the Franklin National Bank in New York). The second reason is that **de jure** deposit insurance is preferable to **de facto** insurance. The public generally believes that large banks will not be permitted to fail, but that smaller banks may fail. Since deposit insurance premiums are imposed on deposits of all insured banks, this **de facto** difference is inequitable.
2. Time-dated deposits (such as CDs, whether negotiable or not) need not be insured, as long as the holder can withdraw funds from the financial institution only at the time stated. (Obligations that permit withdrawal of funds with an interest rate penalty would be classified as funds withdrawable on demand.) Consequently, runs cannot occur with such deposits. In this respect, time deposits are no different from the debt obligations of other companies.[17] Of course, an institution may purchase insurance coverage for these obligations if it wishes. The advantage of this

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[16] Also see Barnett, Horvitz and Silverberg (1977) and Scott and Mayer (1971) for analyses of suggested changes, some of which mirror the ones presented here.

[17] Though some time-dated obligations are payable almost immediately, institutions (and the insurance agency) have incentives to ensure that the amount due at any time is not excessive.

"The present insurance system suffers from a lack of competition among insuring agencies."

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proposal is that holders of time deposits would monitor the issuing institution. Furthermore, the interest rate paid on the deposits could provide the demand deposit insurance agency with the market's assessment of the riskiness of the institution.

3. Commercial and mutual savings banks are regulated by several agencies, which can lead to conflicting authority and a failure to act in a timely fashion. The agency with the principal interest in supervising financial institutions should be the one that must bear the cost of their failure—the insuring agency.[18] Consequently, it should have the sole authority and responsibility for supervising the financial institutions it insures.

4. The present insurance system suffers from a lack of competition among insuring agencies. As a consequence, examination procedures may be too costly and poorly focused. Because they are monopoly suppliers of deposit insurance, the present agencies have less incentive to adopt more efficient and better directed procedures, such as risk-variable insurance premiums, tests of the predictive ability of statistical models, and research on optimally diversified portfolios. Because the regulatory agencies also are subjected to severe political criticism if "their" banks fail, they may be too restrictive in some instances. They should be faced with equating the marginal costs and benefits from failures and failure-reducing measures as are other insurance providers. Consequently, the following changes should be considered:

a. The Office of the Comptroller of the Currency (OCC) should become a deposit insurance agency, initially providing insurance (and supervision) to national banks. The Federal Reserve's Division of Supervision and Regulation should also provide insurance to the member banks it examines. These changes would continue the present examination staffs as they are presently constituted, which would minimize the cost of change. The present FDIC insurance fund could be divided among the three agencies in proportion to the total demand deposits held by the banks they insure.

b. Any deposit insured institution should then be allowed to purchase insurance at the OCC, FDIC, Fed, FSLIC or NCUSIF. Thus there would be five potential competitors. Of course, an agency need not accept applications made to it. Each agency could offer its "customers" whatever terms it wished, much as does any insurance company, so long as the terms are offered equally to all clients that present equivalent risk. An agency should, however, give at least one year's public notice before cancelling the insurance on deposit balances. It also could require an insured bank to authorize the agency to seize its assets, given designated circumstances.

c. Any demand depository institution could obtain insurance from non-government insurers, including other banks,[19] if the insurer were accepted by the chartering agency. The non-government insurer could initiate clauses into its contract with the institution that would give the insurer rights similar to (or even greater than) those held by the government agencies. These might include restrictive covenants as to dividends, specified diversification of assets, minimum equity requirements, audits by CPAs or the insurance company's examiners, pre-agreement to cease practices or to remove officers, and seizure and sale of assets after a stated "danger" point is reached.

5. The preceding proposals do not cover the difficulties of insuring deposits in the face of unpredictable problems in the financial system as a whole, problems not controllable by individual institutions. In our fractional reserve banking

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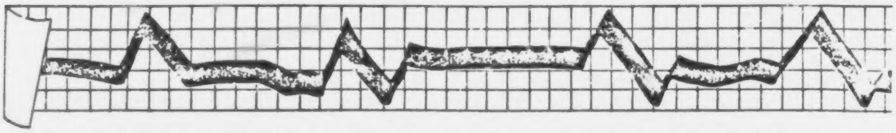
[18] See Benston (1983) for the analysis on which this conclusion is based.

[19] The agency that insures the deposits of a bank offering deposit insurance to other banks can adjust its premium accordingly or take other actions to control the risk.



system, a substantial decline in bank reserves for any reason can cause wide-scale banking failures. Such declines in reserves also are very difficult (perhaps impossible) to predict and, thus, deposit insurance premiums cannot be set actuarially. Therefore, to make non-government supplied insurance feasible, the insurers should in some way be relieved of the cost of failures caused by substantial systemwide declines in bank reserves.

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WHY DID CONGRESS PASS NEW FINANCIAL SERVICES LAWS IN THE 1930s? AN ALTERNATIVE OPINION

The rationale for Congress' passage of legislation is very difficult to establish. Nevertheless, it is important that we attempt to understand the circumstances surrounding the passage of the banking and securities legislation of the early 1930s so that we can assess its contemporary relevance. In particular, if the McFadden Act's restrictions on branch banking were enacted to ensure small banks' survival, would the repeal of the act mean that the financial system would be dominated by nation wide giant banks? If investment banking was separated from commercial banking by the Glass-Steagall Act because the combination of services resulted in fraudulently and unsafely run banks, might not this situation occur again were the statute changed?

Was the fact that the Banking Act of 1933 and the subsequently enacted legislation and regulations establishing and reinforcing a specialized financial services system a reaction by Congress to the failure of many banks and thrift associations in the early 1930s? If it was, should we be concerned that the repeal of the legislation and the removal of restrictions on the services that chartered financial institutions can provide might not result in a future wave of failures?

These questions can be answered from two perspectives. One is careful study of the causes of bank failures and frauds. Some research on this question has been done. Little, if any, identifies branch banking, the combination of commercial and investment banking, or the offering by thrifts of traditional commercial banking services as causes of failures[*]. Indeed, the evidence points to limitations on branching as a major cause of bank failures, since very few branch banks (particularly large banks) failed.

Unfortunately, the effect on bank safety of commercial banks offering investment banking services was not similarly studied. But there is good reason to doubt a causal relationship because very few large money market banks, the banks that tended to offer investment banking services, failed. Since thrifts only recently could offer commercial banking services (and still cannot serve most business customers), we cannot look to the past for guidance. But we can acknowledge that commercial banks that offered mortgages and savings deposits were not more prone to failure for that reason.

The other perspective from which the possible effects of repeal of the Great Depression legislation can be assessed is an analysis of the reasons for these laws having been passed. As an alternative to the bank safety, small-bank-survival hypothesis explaining congressional intent put forth above, I would like to propose a producer self-interest, horse-trading explanation. If this latter hypothesis were correct, repeal of the legislation is unlikely to result in failures, since it essentially was not passed to prevent failures.

Furthermore, since the legislation no longer benefits the institutions, they and the public would be better served by a repeal of legislation that keeps them from changing to meet present demands. And, if concern for the safety of the banking system were not an important reason for the congressional action of the 1930s, there is less reason to fear a repetition of that unhappy time should the laws be repealed.

The 1930s was a time of great financial distress. Over a third (9,096) of the commercial banks failed between 1930 and 1933. Most of these were small, unit banks. The survivors quite reasonably feared that the people would shift their funds to the larger branch banks, since few of these failed. Hence, the small banks wanted federal deposit insurance. The large banks, particularly those in the money centers, didn't need deposit insurance. But they did want to outlaw the payment of interest on demand deposits. The New York banks in particular had tried, at least since 1905, to establish cartel agreements that restricted payments on deposits, particularly those of country banks. But these agreements didn't stick, as some bank or other broke ranks to attract deposits from its competitors.

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[*] See George J. Benston, Bank Examination, The Bulletin, 1975.

At the same time, investment bankers were suffering from competition from banks that were offering investment services. The more prestigious brokerage houses also suffered from competition from other, lower quality brokers, most of whom didn't follow the older houses' standards for prospectuses. Add to this the public's apparent (and mistaken) beliefs that the stock market crash of 1929 and shady dealings of the brokers and bankers had caused the depression, and we have the makings of a big horse trade.

The small unit banks (which, being numerous, carried political clout) won strengthened McFadden Act prohibitions against branching. More importantly, they got the FDIC, which was paid for principally by the large banks. (The FDIC insured deposits up to $5,000 per account but assessed premiums on all deposits.) The large banks got a prohibition against interest payments on demand deposits. The brokers got the commercial banks out of the investment business. They also didn't fight passage of the Securities Act of 1933, which imposed prospectus requirements on all but small issuers of securities (but which exempted banks). And the Roosevelt administration received the credit for taking aggressive legislative action that presumably corrected the alleged abuses of the financial system while preserving capitalism.

The savings and loans are another story. The administration wanted to channel funds into the housing industry. But 526 savings and loan associations had failed. First the administration tried to get the mutual savings banks to expand out of the Northeast. But the savings banks refused; they had survived the depression with hardly a failure (only 10 went under) and were not disposed to taking on new responsibilities. Nor were many commercial banks in a position to expand.

Agents of the newly established Federal Home Loan Bank Board then went to communities and offered savings and loan charters to home builders, lumberyard dealers, real estate lawyers, and others who might benefit from starting an association that would channel funds into their businesses. Bankers couldn't benefit from this coincidence of interest since such related dealings were not considered to be consistent with sound banking practices. Thus many specialized thrift associations were established and, having been given subsidies by way of tax exemptions and having been well-positioned to take advantage of savings during World War II and of the post-war housing boom, they prospered.

But today changes in consumer demands, unexpectedly high interest rates, and improved technology have served to make the 1930s laws punitive. The acts and regulations have prevented or restrained financial chartered institutions from changing effectively. Consequently, other suppliers of financial services have been organized to meet consumer demands and to take advantage of the technology. Whether or not a repeal of the 1930s laws and changes in the regulatory structure are desirable pose important questions that have been much debated. In any event, if this explanation for the 1930s legislation is correct, there seems little reason to fear that changes would result in an unsafe financial system.

George J. Benston

Mr. BENSTON. Effectively, one would be run by the Comptroller's Office with its examiners and supervisors for the national banks, the other by a spinoff of the Fed's examinations officers, and the third by the present FDIC staff or its other people. This would involve no administrative changes. People would keep their jobs and continue to supervise the same banks, but the major difference is that any bank or thrift could now move from one insurance fund to another if it chose to, and if it were accepted. This would put some competition into the market for insurance and result in much greater efficiency in the way that insurance is handled. Some people who reacted to the proposal said that, well, that might mean competition for the borrower, that the funds will try to get clients, a competition for the bottom. But that's very unlikely, because the funds will bear the losses. In fact, such self-destructive competition hasn't happened in the private insurance business. The fact that, if anything, Government insurers would tend to be much too conservative, because they bear the losses and they don't get the gains from greater competition.

Third, repeal of interest payments on demand deposits is certainly something almost everyone—every economist at least—would accept, one, because there's no evidence that these payments had anything to do with bank failures in the 1920's and 1930's and, two, because banks are paying interest anyway, though not efficiently.

The only thing I would add, though, is given that we have deposit insurance, I would put a constraint on the amount of interest that could be paid on demand deposits to something less than the Treasury bill rate, for the reason that it's very simple to operate a scam, a fraud, on the insurance funds by paying above-market rates, getting the money in, and then either outright stealing the money or investing it in long-term bonds and hoping interest rates go down. That I suspect is being done now and the only thing that I'm curious about is why isn't it being done more. It's one of the easier frauds one could perpetrate in this country.

On the other hand, one would also want to constrain the insurance in terms of the $100,000 per account because insured deposits are very prone to fraud.

Essentially, there should be no constraints on branching and basically one would permit banks to operate securities within the bank and not necessarily in its affiliates. The affiliate system is a vestigial organ left over from the way the banks had to operate under the law as it was in the 1920's.

I can see that you've been very patient with me and I suspect I've overdone my time. I thank you very much.

[Complete statement follows:]

PREPARED STATEMENT OF GEORGE J. BENSTON, PROFESSOR OF ACCOUNTING, ECONOMICS AND FINANCE GRADUATE SCHOOL OF MANAGEMENT, UNIVERSITY OF ROCHESTER

THE PRESENT SITUATION

Fifty years ago, in the depths of the Great Depression, legislation was enacted that severely constrained the U.S. banking system. These constraints included: Prohibition of explicit interest payments on demand deposits; controls on time and savings deposit interest (Reg. Q); separation of commercial and investment banking, and new charters became very difficult to obtain. At the same time, some very important constraints were not removed. These included: National banks continued to be subjected to State-imposed restrictions on intrastate branching; interstate branching was not permitted, and specialization in mortgages and savings deposits by thrift institutions was continued, since they were not given additional powers and were given tax and support subsidies through the creation of the Federal Home Loan Bank Board and the Federal home loan banks. Perhaps the presently most important change was the creation of the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC).

These new and continued constraints plus the deposit insurance agencies worked well in virtually eliminating bank failures. As long as interest rates were low and stable, entrepreneurs and consumers had few incentives to get around the regulations by establishing and seeking out new institutions and products. But, when inflation-driven nominal interest rates increased, disintermediation ensued as depositors sought to get value for their funds. Though Congress attempted to stem the tide by extending Reg. Q to deposits in thrift institutions, increasingly inexpensive technology made it profitable for new suppliers to enter the market. At this point, even were it considered desirable to prevent depositors from getting market rates of return on their funds, it probably would not be possible.

At present, many firms have entered the financial services market. Brokers offer interest-bearing checking accounts, banks offer the access to discount brokers, large banks have offices in most major cities in which all types of banking is conducted except direct deposit taking, insurance companies have acquired brokers and banks, and so forth. These developments are salutatory, for two reasons. The most important is that consumers are better served as more suppliers vie for their business. The other is that we are being forced to reconsider the public benefits and costs of the 1930's regulatory system.

Indeed, it might be well to reconsider the regulation of banks generally. Banks have been regulated in almost all countries and almost from the beginning of commercial economies, even when other businesses were free to operate unconstrained. The reasons for the past and present regulations should be delineated and analysed before reforms are enacted. It may be that regulations now seem obsolete, but if the conditions that gave rise to them were to reoccur, we would regret their removal. It also may be that conditions have changed, such that the present set of regulations are irrelevant and harmful. In this event, we should welcome thir removal.

PAST AND PRESENT REASONS FOR BANKING REGULATION

I undertook an analysis of the past and present reasons for banking regulations in a paper published in The Journal of Bank Research (Winter, 1983), which I have submitted for the record. I was able to delineate nine reasons. These include five that once were important, but that are not relevant to us: Taxation of money (seignorage), prevention of centralized power, bank solvency and the effects of failures on the economy, the social goal of making banking services generally available, and support of housing and other attempts to allocate credit.

Taxation was the historically most important reason for restricting the entry of firms into banking, since this enhanced the monopoly that the sovereign could own or tax. It is no longer relevant since, if the Congress wants to tax money, it can continue to require banks to hold non-interest bearing reserves.

The prevention of centralized power is unnecessary because the U.S. public is served by an enormous number and diversity of suppliers of financial services. The extension of almost full banking powers to thrifts and the entry of nonbanks into the market has further reduced the possibility that power could be centralized. In addition, the antitrust laws apply to financial service institutions as well as to other enterprises. But, if this is still considered a concern, it can be solved best by removing the remaining regulatory bars to entry. The continued prohibitions against intra- and interstate branching, and the barring of commercial banks from offering underwriting and other security investment services represent the most important remaining constraints.

Bank solvency is no longer a problem for depositors because of the existence of deposit insurance. Nor is the formerly very destructive effects of bank runs a concern, since runs have been obviated by deposit insurance. But, as is discussed below, deposit insurance brings other problems.

The provision of banking services is virtually complete. Indeed, the entry of new institutions into the market for financial services enhances this social goal. The other often mentioned social goal of support for housing and other allocations of credit is no longer thought to be enhanced by banking regulations since experience has taught us otherwise. In fact, deposit interest rate controls and the enforced specialization of thrifts in mortgages and savings has been detrimental to the desirable goal of a predictable flow of funds that are available for home building and sale.

Four reasons for bank regulation still are possibly relevant: money supply control, the prevention of invidious discrimination and unfair dealing against persons, avoidance of competition, and the protection of the deposit insurance funds.

Money supply control need not be accomplished through bank regulation. Actually, there is no direct connection between the two. The Federal Reserve controls the money supply via open market operations. Changes in reserve requirements also can be used for this purpose, but this method is coarse. Lending to banks has been used, but this does not require the Federal Reserve to be involved in bank regulation. All the Fed needs in information about the banks that want to borrow, much as a bank needs information from its borrowers.

The prevention of invidious discrimination is a generally accepted social goal that is expressed in the Equal Credit Opportunity Act and similar legislation. These acts are enforced with field compliance examinations. But, these are imposed only on chartered depository institutions. This seems very strange, particularly as these institutions rarely are charged with invidious discrimination. If field examinations are thought desirable, they should be imposed on all lenders—nonbanks, department stores, gasoline dealers, etc.

Finally, we come to the only remaining currently important reasons for bank regulation—avoidance of competition and protection of the deposit insurance funds. Much of our present and past banking regulations are and were designed to restrict the ability of people to compete. As I discuss in a short note, "Why Did Congress Pass New Financial Services Laws in the 1930's? An Alternative Opinion" (Economic Review of the Federal Reserve Bank of Atlanta, April 1982, submitted for the record), there is good reason to believe that the 1930's legislation was enacted more to shield institutions from competition and to benefit producers at the expense of consumers. In particular, the small unit banks, which were characterized by high rates of failure, wanted a continuation of the anti-branching laws. But they had reason to fear losing deposits to the larger banks, relatively few of which had failed. Therefore, the small banks also wanted deposit insurance. The large, money center banks wanted interest on demand deposits to be prohibited. Carter Golembe estimated that the amount the big banks saved in deposit interest (primarily on the deposits of banks) almost exactly equaled the FDIC insurance premiums these banks paid on their uninsured deposits. The investment bankers wanted the commercial banks from underwriting. But the Administration wanted passage of the Securities Act of 1933. The Act was passed, banks were exempted, and the Glass-Steagall Act's separation of commercial and investment banking also was enacted.

Finally, there is deposit insurance. As noted above, deposit insurance eliminates concern for bank runs, but also the concern of depositors for the safety of their funds. Much has been written and spoken about deposit insurance and the necessity for reform. I also have written an article on this subject, which I also submit for the record ("Deposit Insurance and Bank Failures," Economic Review of the Federal Reserve Bank of Atlanta, March 1983). At this point, I want to emphasize that the only remaining public interest in bank regulation is the well-advised concern of the deposit insurance agencies for the safety of their funds. These are the agencies that have a public interest in how banks are run. Except for those who would continue to use regulations to restrict the ability of companies to serve consumers, there is no other reason to continue the regulation of banks in a manner differently from the way other firms are regulated.

SUGGESTIONS FOR CHANGE

The issues under consideration today were the subject of a four day conference on "The Future of American Financial Services Institutions" organized by the American Assembly on April 7-10, 1983 at Arden House in Harriman, N.Y. This Sixty-fourth Assembly, which I directed, brought together some sixty participants. They included the executive directors of almost all banking associations, bankers who managed large and small banks and thrifts, insurance and securities company executives, Congressional staffers, regulators, and academics. We met in three groups of twenty in four structured sessions of over three hours each. Most of the issues were discussed and debated, and, where possible, a consensus was reached. After the fourth session, I met with the discussion leaders and rappoteurs of each group and we wrote a consensus position paper. The next day the group met as a whole, debated each paragraph and often each sentence, deleting some, changing others, and adding new points. The result of this process is the Final Report of the Sixty-fourth

American Assembly, which I submit for the record. In short, the group recommended the following:

There should be no constraints on the provision of financial services, other than reasonable standards of capital, competency, and probity, with two exceptions:

> Institutions that accept governmentally insured deposits should not be allowed to provide services other than fiancial services and services closely related thereto;
>
> Similarly, institutions that provide nonfinancially related services or products should not be able to own or control institutions that accept governmentally insured deposits.

Government insurance, approved private insurance, or some combination thereof, should be required for demand transaction accounts that are not fully backed by liquid assets and for savings and time deposits. The insurance agency would be the one that had a regulatory interest in the insured banks. The rate charged should reflect the risk.

There should be no constraints on failures, mergers, or branches.

There should be no controls on interest paid or charged.

The Federal Reserve should not be directly involved in the supervision of depository institutions except as necessary to protect its ability to conduct monetary policy.

If reserves are required against deposits, interest should be paid on the required balances.

All consumer protection legislation should be reviewed on a cost-benefit basis to ensure that it does not adversely affect consumers to a greater degree than it benefits them.

My suggestions

The analysis presented above and in the papers submitted for the record lead me to suggest the following legislative changes:

> Repeal all legislation that constrains entry in the provision of financial services, with the exception of requiring deposit insurance on transactions demand balances and a total of $20,000 per natural person for time deposits.
>
> Split the FDIC into three insurance funds. One would insure the deposits of the national banks and be run by the Office of the Comptroller of the Currency. The second would be run by the present FDIC and insure the deposits of state, nonmember banks. The third would be newly established and insure the deposits of the Federal Reserve member banks. The insurance reserves would be divided according to the deposits of the insured institutions. Thus, the present examination and supervision staffs would continue to do what they have been doing.
>
> Permit banks and thrifts to be insured by any of the three insurance agencies and the FSLIC. Thus, some degree of competition would be established. Since the agencies would bear the costs of poor supervision and unsafe banking practices, there would be no incentive for them to compete foolishly for clients. But they would have incentives to establish cost-effective examinations and insurance charges.
>
> Restrict the Office of the Comptroller of the Currency and the Federal Home Loan Bank Board to chartering depositing institutions by determining that the institutions have the required depositing insurance. The agencies would have no other authority or responsibilities, other than managing their deposit insurance funds.
>
> Repeal the prohibition of interest payments on demand deposits. This prohibition was enacted primarily to allow the money center banks to save the interest they would have to pay to country banks and to allow banks generally to form a cartel against depositors. The prohibition had nothing to do with the reduction of bank failures. In any event, most banks now pay interest on most demand deposits, but in inefficient ways. Repeal also would encourage depositors to leave their funds with banks, thereby reducing velocity and enhancing monetary control. However, a floating ceiling on interest rates of 100 or 200 basic points below the Treasury bill rate should be enacted to prevent transactions balances from serving as vehicles for schemes to defraud the deposit insurance agencies.
>
> Remove reserve requirements since the Federal Reserve can control the money supply via open market operations. Alternatively, have the Fed pay banks interest on required reserves at the average rate earned on the Fed's portfolio.

Permit federally chartered depository institutions to establish branches wherever they wished, as long as their deposit insurance agency doesn't object. The elimination of branching restrictions would permit banks to serve customers in their natural market areas, even where these crossed State lines. As importantly, banks could establish private check clearance systems if they were permitted to pick up checks anywhere they wished (presently, this is considered to be branching).

Permit banks to offer underwriting and securities transactions services. The conflicts of interest that were alleged to have occurred when banks offered these services have never been demonstrated to have occurred. Nor is the possibility of such conflicts greater for banks than for brokers and underwriters.

Senator GORTON. Thank you.
Mr. Eisenbeis.

STATEMENT OF ROBERT A. EISENBEIS, PROFESSOR, SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL, CHAPEL HILL, N.C.

[Complete statement follows:]

INTRODUCTION

It is a pleasure to be here today and to express my views on S.2134, the Depository Institutions Holding Company Act Amendment of 1983, and S.2181.the Financial Services Competitive Equity Act. Because of the extremely wide ranging aspects of these two reform bills, it is not possible to comment on all the specific provisions. In the limited time available to me I'd like to discuss several issues that bear directly on the underpinnings of this legislation. These relate to the provisions (1) that expand the permissible powers of BHC and confine permissible BHC securities activities to separate affiliates, (2) that define a bank, (3) that deal with the criteria for new banking activities, (4) that impose regulations on the insurance activities of BHCs, and (5) that authorize the payment of interest on reserves held against certain transaction accounts.

SEPARATE AFFILIATE APPROACH TO EXPANDING BHC ACTIVITIES

In early 1982 I testified on the Bank Holding Company Deregulation Act of 1982 before the Securities Subcommittee of this Committee. That bill contained provisions to expand BHC nonbanking activities essentially similar to those contained in the bills before us today. I argued strongly at that time, and continue to believe, that if banking organizations are to remain an important force in financial markets, then measures must be taken to ensure that they are not placed at a competitive disadvantage to less regulated firms. This means that unnecessary and costly regulations, such as noninterest bearing required reserves and deposit rate ceilings, must be removed (fortunately this has been nearly accomplished in the case of rate ceilings). Furthermore a broadening of financial powers, such as is being proposed, is in order. However, so long as it is public policy to attempt to minimize the likelihood of financial crises by insuring deposit claims, then a strong argument can be made that this expansion of powers should take place within banks where the activities can be monitored, extreme risks can be identified and proper pricing of insurance can take place. In the interests of time I've attached that testimony for the record, but I'd like to briefly indicate the reasons why I counsel strongly against the separate affiliate approach.

The proposals to expand the powers of bank holding companies, and particularly the provisions pertaining to their securities activities, are grounded in the belief that it is possible to partition a banking organization into two components: a regulated segment consisting of federally insured affiliated banks and a less regulated segment consisting of the parent company and its nonbanking affiliates. The aim is to isolate and protect banks from risk taking and abuses, and thus to limit deposit insurance risks flowing from the rest of the organization, which would be permitted to operate in a less regulated and relatively unsupervised fashion. As long as nonbank affiliates are isolated by regulations, supporters of the proposals argue that no harm would befall subsidiary banks and the risks to safety and soundness would be controlled.

Such a policy is appropriate if it were truly possible to isolate banking subsidiaries from the rest of the organization. Experience, however, indicates that when activities of the parent, subsidiary banks and nonbanking affiliates are determined by centralized policies, then it becomes difficult, and indeed impossible, to isolate the insured banks from risk taking in the rest of the organization. The fact that most of the nation's money center banking organizations are dominated, both in terms of resources and management, by their bank subsidiaries makes this implicit association especially strong in the eyes of the market. Moreover, there is ample market evidence, the 1973-74 REIT experience being one of the strongest examples,that bank holding companies will draw on the resources of the entire organization , including subsidiary banks, to avoid the failure of an important subsidiary or affiliate with which they are associated.[1]

The history and review of the operations of bank holding companies indicate they tend to operate as integrated firms

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[1] Chase and Waage(1983) while arguing for the separate affiliate approach on the basis of the concept of "corporate separateness," demonstrate conclusively the economic realities and incentives for companies behaving as integrated firms. They also provide other examples of nonbanking financial firms that have bailed out troubled affiliates.

rather than a collection of truly independent companies.[2] In such circumstances, regulatory policies designed to isolate heavily regulated bank subsidiaries from the rest of the organization only create additional incentives for the organization to attempt to circumvent banking regulations and to spin more and more activities into the less heavily regulated segments of the organization. To the integrated firm, total profits are being maximized and not necessarially the returns from separate subsidiaries. Thus it does not matter where, within the firm, a particular function is being conducted as long as its contribution to total firm profits is optimized.

This behavioral response to regulation is of importance for several reasons. First, the shifting of activities from bank to nonbank subsidiaries may serve in the long run to increase the ties between the subsidiaries and make the organization more of an integrated firm with respect to the exposure to risk than it was before. Second, to meet the pressures of increased competition, bank holding companies have powerful economic incentives to conduct as many of their activities as possible in the less regulated portion of their organizations whenever regulations become binding and costly constraints. The implication is that it is neither practical nor possible to segment risk-taking or to separate the financial health of part of the organization from the whole. The only effective way to isolate subsidiaries

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[2] See Whalen(1982a,b), Rose(1978) and Murray(1978).

would be to impose regulations to make them totally independent except for the passive ownership of the parent. The problem with such a policy, however, is that it would negate the basic rationale for establishing the holding company which is to take advantage of beneficial synergies of a financing or operational nature that might result from conglomeration.[3] Finally, the shifting of functions from the regulated to the less regulated segments of a holding company poses special policy problems when a parent company or its nonbank affiliates issues uninsured liabilities that are close substitutes for the insured liabilities of its subsidiary banks. As a greater and greater portion of financial liabilities shift from insured to uninsured status, the stabilizing benefits of deposit insurance are lost. Unless the insuring agencies choose implicitly to guarantee such claims--as appears to be the case when one examines how large failed or troubled banking organizations have been resolved--then the risks of financial crises are substantially heightened. The efficacy of this insurance can only be maintained by minimizing the inducements to shift funds from insured to uninsured status. This requires either extending regulation to the consolidated entity or instituting deposit insurance reforms to price for risk(of the consolidated entity). The irony of the proposed legislation is that it not only provides inducements for banking organizations to conduct activities outside of the bank subsidiaries and also dilutes the insuring agencies' ability to assess and control their risk exposure.

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[3] Chase and Waage(1983) argue on the basis of standard finance theory for a policy of "corporate separateness." However, standard portfolio theory, in its most simplified form, also states that absent synergies, there is no benefit to shareholders from diversification due to conglomeration. They can achieve the same benefits of diversification in their own personal portfolios.

DEFINITION OF A BANK

To the extent that it is not possible to implement a policy of "corporate separateness," then the proposals to permit various types of organizations to own subsidiaries which issue federally insured liabilities immediately come into question. The debate has crystallized around the problem of the appropriate definition of a bank. I believe, however, that worrying about which institutions meet the legal definition of a bank for purposes of the Bank Holding Company Act is a false issue. The critical issues are whether and what institutions are to be permitted to issue federally insured liabilities. I believe that federal insurance of some liability is necessary to ensure the integrity of the money supply.[4]

But it must be recognized that, if not properly priced, federal insurance carries with it an inherent subsidy and competitive advantage. More importantly, it also provides inducements to take on increased risk. Therefore, the government, as the only viable insuring agency, has the legitimate and necessary responsibility to ensure that it is not placed at undue risk. Again, because of the infeasibility of implementing a policy of "corporate separateness", this means either extending bank regulation and supervision to the parent company and affiliates or redesigning the deposit insurance scheme to charge for risk regardless of institutional structure.

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[4] Indeed, if there is only one such liability, then there is greater ability to define the money supply.

CRITERIA FOR DETERMINING PERMISSIBLE BANKING ACTIVITIES

Having indicated the importance of controlling risk, because of the links to deposit insurance, in regulating bank holding company activities, it is common to suggest that risk be an important criterion in deciding upon permissible activities. Within the context of a properly priced deposit insurance scheme, however, risk is not a particularly useful criterion to employ for several reasons. First, few activities are inherently risky. Management makes them risky. Second, risk is a relative and not an absolute concept. Risk can only be judged relative to its affects on the returns of the firm proposing to engage in the activity. For example, an activity, when added to a particular firm's portfolio may increase diversification and reduce the variability of that firm's earnings. That same activity when added to another firm's portfolio may increase its risk.

If risk is not a particularly useful criterion, then what is? I believe that the answer lies in the other traditional reasons we have chosen to limit the scope of banking activities, and those are concerns for conflicts of interest and concentration of economic power.

Mr. Corrigan(1983), President of the Federal Reserve Bank of Minneapolis, has provided a particularly interesting approach to this problem when he argues that we should attempt to ensure "the impartiality of the credit decision making process." Although Mr. Corrigan does not spell out exactly what he means there are two possibilities which have occurred to me. The first is that a borrower's access to credit should be independent of the transaction in which he proposes to engage. This option is not too likely, since we have long permitted the establishment of credit granting facilities to cross subsidize the purchase of real goods and services. As long as adequate sources of credit exist and coercive tying is prohibited, little harm could come from such activities. The other possibility is that the owner of a credit source might discriminate against a competiting producer of real goods and services. This concern is probably greatest when alternative sources of credit are diminished which in turn is more likely when financial and commercial resources are concentrated among a few.

This brief look suggests that policies to assure competition, to avoid concentration of resources, and to avoid conflicts of interest remain a relevant concern in reviewing reform proposals. They also suggest that these issues are relatively greater where commercial credit is concerned than in the consumer credit area.

EXPANDED INSURANCE POWERS FOR BANKING ORGANIZATIONS

One of the most overworked arguments against banking organizations being permitted to enter the insurance brokerage area has been the potential for coercive or illegal tying between the granting of credit and the sale of insurance. In order for coercive tying of insurance to take place, a banking organization must have some degree of monopoly power in the credit markets. The facts have never supported the case that coercive tying was ever a significant problem.[5] Moreover, the pace of financial innovation, the rapid entry of new suppliers into credit markets, the recent expansion of the asset and liability powers of thrift institutions and the reduction in dependence of consumers on local sources of credit make it even less likely that the conditions for coercive tying will exist.

Furthermore, to the extent that concerns about potential abuses persist, however, I see no grounds for singling out banking organizations out for special regulatory treatment from other firms that both offer insurance services and provide credit to consumers. In the interests of not having differential regulatory burdens bestow competitive advantages not justified by productive efficiency, the provisions concerning tying should extend to all competitors.

INTEREST PAYMENTS ON RESERVES

As long as it continues to be federal policy to impose reserve requirements as a tool of monetary policy, I believe that the proposals to pay interest on required reserves held against deposits are both necessary and long overdue. As interest rates rose during the 1970s and early 1980s, reserve requirements, together with Regulation Q, were among the most important stimuli to financial innovation. The opportunity costs that resulted in that environment created financial opportunities for both depository and nondepository financial institutions to innovate close substitutes for reservable liabilities. The explosive growth of money market mutual funds, for example, was almost entirely due to binding reserve requirements and deposit rate ceilings.

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[5] See the recent survey of the evidence in Chase and Brown(1984).

The problem is that the proposals is that they don't go far enough. Interest should be paid on all required reserves held at the Federal Reserve. Equally important, the rate paid should not be tied to the return on the Federal Reserve's portfolio. There are two reasons for this. First, we don't want to create a situation where the discount rate is below the rate earned on the Federal Reserve's portfolio and create an incentive for institutions to borrow from the Federal Reserve to bid to attract money market deposit accounts and Super NOW accounts, so as to arbitrage the rate paid on the Federal Reserve's portfolio. Second, the rate paid on required reserves could be a useful tool of monetary policy in addition to open market operations.

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Senator GORTON. Thank you.
Mr. Horvitz.

STATEMENT OF PAUL M. HORVITZ, PROFESSOR, DEPARTMENT OF FINANCE, UNIVERSITY OF HOUSTON, HOUSTON, TEX.

Mr. HORVITZ. Thank you, Senator. It's a pleasure to participate on this panel to discuss this broad and far-reaching legislation. This legislation I think is much broader than other deregulation legislation that's been considered by the Congress.

[Complete statement follows:]

Statement of

Paul M. Horvitz

Judge James A. Elkins Professor

of Banking and Finance

University of Houston

Before the

Committee on Banking, Housing and Urban Affairs

U.S. Senate

March 13, 1984

Banks in the United States have long been subject to three major types of restriction: ceilings on the rates that could be paid on deposits, limitations on the types of activities in which they can engage, and geographical restrictions on some of their operations. Over the last several years there has been a great deal of discussion of deregulation of the financial system, and some important legislation has been enacted--the Depository Institutions Deregulation and Monetary Control Act of 1980, and the Garn-St. Germain Depository Institutions Act in 1982. The primary thrust of that legislation was on the removal of interest rate ceilings on deposits. While I do not underestimate the importance of deregulation of deposit rates, since that type of restriction has had the most adverse affect on consumers and the efficiency of financial markets, nevertheless, our progress on removal of other unnecessary forms of restriction on the operations of depository institutions has been almost nonexistent.

Banks and other business firms have been pushing at the boundaries of allowable activities, and have exploited those loopholes in existing law that they have been able to find. But the actions of the Congress and the regulatory agencies have been in the direction of increased regulation and restriction with respect to allowable activities and geographical scope of activities. For example, the Garn-St. Germain Act restricted the opportunities for increased bank activity in the insurance business. Further, by setting forth a set of procedures by which emergency combinations of commercial banks and savings and loan associations could be approved, the Act seems to prohibit mergers of healthy banks and thrifts. The Comptroller's moratorium on chartering non-bank banks is a restriction on the opportunities for interstate banking.

The legislation we are discussing today makes a substantial start at dealing with a number of issues related to the allowable activities of banks, bank holding companies, and thrifts. Whatever legislation results from consideration of the issues by this Committee and the Congress as a whole will not be the last legislation on this subject. You will be dealing with issues of regulation of the financial services industry for many years to come.

It is important to recognize that much of the legislation of the last several years, and much that is in the bills before you today, is unnecessary. We did not need DIDMCA or Garn-St. Germain to eliminate interest rate ceilings on time deposits. The Federal Reserve Board and the FDIC had the authority to remove ceilings, or at least to raise them to levels where they would not pose a problem. The Congress had to step in only because the agencies failed to act in the public interest. (Congressional action is needed, of course, to deal with the prohibition of interest on demand deposits, and that is a desirable part of S. 2181.)

A similar comment can be made about the provisions of S. 2181 dealing with bank and bank holding company activities in real estate and the insurance business. The Bank Holding Company Act Amendments of 1970 delegated to the Federal Reserve the authority to determine which financial activities were appropriate for bank holding companies. That approach was taken because it was thought that it was preferable to having the Congress debate every entry on the laundry list of potential activities. Nearly everyone thought that over time, and on the basis of rational consideration of economic and financial factors, the Federal Reserve would broaden the list of allowable activities. In fact, the Federal Reserve has failed to respond to its responsibilities in this area. Some of the decisions made by the Federal Reserve with respect to Section 4(c)(8) powers have been ludicrous. At one time the Federal Reserve determined that financial consulting was not an appropriate activity for bank holding companies, even though banks have engaged in that activity from their very beginning. More important has been the Fed's refusal to allow the acquisition of savings and loan associations by bank holding companies. That decision has clearly been based more on political considerations than on economic logic. The Federal Reserve could have determined the appropriate extent of bank holding company involvement in real estate and insurance, but preferred to avoid dealing with such controversial issues.

I suppose, if decisions on these matters are going to be made on political grounds, I am more comfortable with their being made in Congress in the light of public scrutiny than behind the closed doors of the Federal Reserve Board. It is unfortunate, however, that the 1970 experiment in delegation of authority to the Federal Reserve failed, because I think these are matters that do not really warrant attention at the Congressional level. Perhaps all that is needed is a Resolution calling on the Federal Reserve to start paying attention to the intent of Congress as represented by the Bank Holding Company Act Amendements of 1970.

While I applaud the general thrust of much of S. 2181, I am not prepared to comment on the specifics of each of the matters covered. I would criticize it as to timid if I viewed it as the final Congressional statement on allowable activities for financial institutions. Since I am confident that further legislation will be forthcoming, the modest liberalizations of powers appear reasonable at this point.

The one specific area in which I have done some recent work relevant to the provisions of the legislation is that of real estate equity investment. In connection with a research project sponsored by the American Bankers

Association, I and two associates at the University of Houston reviewed commercial bank experience with REITs during the 1970s, and investigated the experience of Texas savings and loan associations in their real estate investment activities under the relatively liberal Texas law. I would like to review briefly the results of those two studies.

The commercial bank experience with REITs was, of course, not very good. It is sometimes argued that that history is a good reason why commercial banks should not be granted broader powers to take an equity position in real estate. But that is a misreading of the experience. Banks were advisors to REITs, but could not be owners. The incentive structure in the REIT business was wrong for the banks. They were paid, generally, on the basis of the size of the REIT rather than long-run performance. Front-end fees were also part of the compensation package, particularly for back-up lines of credit which were not expected to be called upon. As a result, there were strong incentives to push out loans as rapidly as possible. Moreover, REITs were required by the tax laws to pass through at least 90% of their annual income to their shareholders. They were prohibited, in effect, from building up a reserve or capital cushion against the inevitable downturns that occur in real estate markets. Finally, the bank-sponsored REITs were primarily in mortgage or construction lending. That was where commercial banks had experience and, they thought, expertise. There were very few bank-sponsored equity REITs in which the REIT took ownership position in real estate investments. As it turned out, the equity REITs were the most successful part of the business, and several (including some that were bank-sponsored) continued to make dividend payments all through the 1970s. The bulk of bank losses in the REIT experience were on loans to REITs. But banks have always had the authority to make loans. They key issue is whether banks should have authority to take an equity position in real estate investments. Bank experience with REITs in the 1970s is not, in my view, an argument against such authority.

Our investigation into the experience of Texas savings and loans in exercising their ability to participate in real estate ventures is more relevant. It is difficult to quantify this experience, since good data are not available, but in the aggregate, it is clear that savings and loans have profited from equity investments in real estate. A number of institutions have undertaken projects that are extremely risky by traditional banking standards, and some have suffered losses. (Some of the losses have resulted from transactions that are illegal or have involved fraud. Evaluation of the experience of thrifts institutions should not be influenced by such cases since bank owners intent on looting the institution through fraud and illegal activities already have sufficient avenues available to them. Liberalization of the law with respect to equity investments should not increase the number of such incidents.) There is no doubt that some of the projects being financed by savings and loans in Texas today involve a high degree of risk. In relating that experience to the probable behavior of commercial banks, should they be granted similar powers, two factors should be kept in mind.

First, many savings and loans are in very weak condition. Net worth is very small in relation to the size of the institution, and for some is negative if assets are evaluated on the basis of market values rather than book. This condition provides incentives for excessive risk taking. An insolvent institution has nothing to lose from taking great risks. In fact, taking a flyer may be the only hope of a return to solvency. It is unlikely that commercial banks, operating with higher capital ratios, will be tempted by the riskiest of opportunities available to them.

Second, risk must be evaluated in terms of the entire portfolio rather than on a project-by-project basis. The addition of a risky investment to a portfolio may actually reduce risk if the new investment has expected returns which are negatively correlated with the existing portfolio. That is more than a theoretical possibility when we consider equity investment in real estate by depository institutions.

Bank depositors like the liquidity of short-term deposits, while borrowers prefer the stability of long-term, fixed-rate loans. The bank that accommodates the preferences of its customers will find itself with relatively short-term liabilities and long-term assets. That bank will be vulnerable to an increase in interest rates which will increase its interest costs more rapidly than its interest income. That is exactly the problem thrift institutions have faced in the last few years. A substantial rise in interest rates is likely to be associated with an increased rate of inflation. One way in which a depository institution can hedge against that risk is by having an ownership interest in real estate. Inflation is likely to increase rental income and the price of residential and commercial property. Thus the real estate investments may behave in a manner opposite to the fixed-rate assets in the bank's portfolio.

I do not want to overstate this consideration. We do not know precisely how rents and property values respond to inflation. Many properties are negatively affected by the higher interest rates that accompany inflation. I would argue, however, that this is a matter deserving analysis and research. We should not limit bank investment in real estate on the basis of considerations of the riskiness of individual projects without taking into account its place in the portfolio as a whole. Some limit may be appropriate, but the limits in S. 2181 are very restrictive--much more so than those that now prevail for savings and loans. Further, it is not clear to me that requiring such activities to be limited to separate holding company affiliates is an appropriate means of dealing with concerns about risk.

While I have not considered the subject more than casually, it strikes me that similar considerations may apply to the insurance business. In particular, the long-term nature of the liabiities of life insurance companies may fit well with the short-term liability structure of some depository institutions. Moreover, many banks and thrifts have networks of branches that may not be economic now that market rates must be paid on most deposits. The ability to sell additional products, such as insurance, through these facilities, may be an important contributor to continued consumer convenience.

It is difficult to summarize one's views about proposed legislation as complex and far-reaching as that which we are discussing today. I am less troubled by considerations of risk when investors have their own money at stake. One way of resolving some of the thorny problems is by assuring that the institutions involved are operating subject to a meaningful capital requirement. While it may not be feasible in the current market to require depository institutions to raise additional equity capital, it would be feasible to impose a requirement in the form of subordinated debt. Such a requirement could apply to banks and to thrifts, and to both stock and mutual institutions. Such capital provides protection to the federal deposit insurance agencies, while the need to sell such securities provides a form of market discipline. With such a requirement in place, we can be more comfortable with financial institutions taking on whatever increased risks might be involved in the new activities provided for in this legislation.

Senator GORTON. Thank you, Mr. Horvitz.

Mr. Kane.

STATEMENT OF EDWARD J. KANE, PROFESSOR, DEPARTMENT OF ECONOMICS, OHIO STATE UNIVERSITY, COLUMBUS, OHIO

Mr. KANE. Thank you, Mr. Chairman. You are to be congratulated for your courage and stamina in committing yourself to stand up to 1 hour of academic lectures on the policy for the evolving structure of the financial services industry. I think the rest of your committee ought to owe you for this.

Senator GORTON. They do. [Laughter.]

[Complete statement follows:]

U.S. Senate Committee Banking,
Housing, and Urban Affairs
March 13, 1984 Hearings on S. 2134, S. 2181, and S. 1609

STATEMENT ON THE STRUCTURE OF THE FINANCIAL-SERVICES INDUSTRY

Edward J. Kane
Everett D. Reese Professor of Banking and Monetary Economics
The Ohio State University

During the 1980s, regulatory reform in financial services has occurred as frequently as tax reform, which is to say as often as the House of Representatives has stood for re-election. However, unlike tax-reform legislation, successive financial-reform bills are each intended to provide a lasting solution to the problems they address. When "permanent" solutions must be significantly emended within two years of their enactment, it should be clear that the solution team's conception of the underlying problem neglects one or more fundamental elements.

My goal this morning is to identify two such elements and to show that neglecting them -- as the bills before us this morning continue to do -- serves merely to transform rather than to solve perceived problems of financial-industry structure. To see that underlying regulatory problems tend to shift into new forms when only their symptoms are treated, we have merely to look at how the financial-services industry has evolved since the Depository Institutions Deregulation and Monetary Control Act of 1980.

When this Act was passed four years ago, Congress perceived the pressing problems of financial reform to be the financial weakness of thrift institutions and a progressive loss of federal regulatory jurisdiction conceived then as merely a Federal Reserve membership problem. The DIDMC Act proposed to solve the first problem by lifting restrictions on thrift-institution asset and liability powers (a policy carried even further in the interim by the Garn-St Germain Depository

Institutions Act of 1982) and to solve the second problem by extending Federal Reserve reserve requirements to the roughly 9,000 nonmember commercial banks, 5,000 S&Ls, 500 mutual savings banks, and 22,000 credit unions then in existence. Four years later, thrift institutions are weaker than before, the number of institutions subject to reserve requirements has declined substantially, and the Federal Reserve is fighting to re-establish jurisdiction over so-called nonbank-bank affiliates of financial-services holding companies and to prevent changes in state laws from undermining federal laws intended to exclude deposit institutions from interstate deposit-taking and from the securities, insurance, and real-estate business.

The untreated malady underlying both the original and the transformed problems is concealed by a narrow conception of the forces driving financial change and an overestimation of the efficacy of regulation. First, Congress needs to recognize that technological change is neither the only, nor even necessarily the main force behind the contemporary desegmentation of financial-services competition. Destabilizing incentives established by the systematic overextension and mispricing of federal deposit-insurance guarantees and the inadequacy of related failure-resolution policies contribute substantially both to the continuing weakness of thrift institutions and to the continuing breakdown of the inherited system of legal restrictions on product-line diversification by financial-services firms. Second, lawmakers and the heads of regulatory agencies need to work with rather than against market incentives. They must frame rules that concede the extent to which competition, rather than lawmakers' pie-in-the-sky intentions, ultimately determines the regulatory structure under which the financial-services industry operates. Regulation-shaping competition occurs on two levels: (1) between regulated institutions and creators of substitutes for regulated products, and (2) among alternative state and federal suppliers of regulatory services. Regulators need to recognize that the enforceability of exclusionary rules and portfolio requirements depends on the opportunity cost of circumvention.

To an important extent, managers of U.S. financial-services firms may choose the set of laws and the particular regulatory bodies by which they are governed. Both by undertaking relatively minor changes in the corporate structure or product lines of their firms and by backing up industrywide lobbying pressure with the threat or promise of making more such changes, regulated firms can systematically cast off regulatory burdens they judge too heavy to bear.

Political and Economic Dimensions of the Changing Regulatory Structure

The bills before us this morning implicitly acknowledge that opportunities for regulatory avoidance fostered by technological change and organizational adaptation have combined to defeat the system of exclusionary regulation established in the 1930s. The operative issue is not so much whether to dismantle cross-industry barriers to entry into different geographic and service areas, as how fast and in what order to eliminate them. Conflicts over reapportioning regulatory turf impart political significance to the order and speed with which these barriers are removed, but it seems appropriate this morning to concentrate on the economic problem. The economic problem lies in the interaction between the demise of barriers to geographic and product-line diversification and the aggregate risk exposure of the federal deposit-insurance agencies, particularly the FDIC and FSLIC. I believe that weaknesses in the economic design of the deposit-insurance system lie at the heart of observed problems in financial-industry structure and that a permanent solution to these problems cannot be fashioned until these weaknesses are corrected.

Existing deposit-insurance guarantees are underpriced and far too sweeping. The pricing, coverage, and failure-resolution schemes now in place for deposit insurance generate powerful incentives for nondepository institutions to acquire insured S&L or nonbank-bank affiliates, for depository institutions to expand their operations into innovative activities, and for large depositors to spread their money in $100,000 pieces across a multitude of depository firms without concern for the financial condition of these depositories.

The basic problem is that the pattern of explicit premiums (1/12 of one percent of an institution's total deposits) is not sensitive to differences either in interest-rate volatility or in an institution's leverage or operational risk. Because this premium structure subsidizes client risk-taking, it creates opportunities for risk arbitrage. To close these opportunities, deposit insurers are led to ration client risk-taking quantitatively. Capital-adequacy requirements and supplementary sanctions against specifically disapproved forms of risk-taking function as rationing devices or implicit premiums that make the pursuit of bureaucratically recognized forms of risk progressively more expensive.

Distortions Caused by Regulatory Lags

However, such a system cannot penalize managers for taking risks whose dangers bureaucrats either have not yet identified or are politically powerless to sanction. In a world of rapid technological and structural change, reactions of politically constrained regulators to the economic consequences of unfolding events inevitably lag market perceptions. As a result, bureaucratic attempts to ration risk-taking shift the margin of risk arbitrage to nontraditional activities and combinations. Effectively, a strategy of rationing risk-taking creates a two-price system in which insurance on new forms of risk-taking is inevitably priced too low. This leads dynamically to a continual expansion in the types of risks insured institutions take.

Resulting policy problems turn on two points. First, regulatory lags prevent quantitative ceilings on risk-taking from eliminating deposit-insurance subsidies. Second, the effect of regulatory lags is more severe, the more rapidly operative risks are expanding. Today, operative risks are growing at an unprecedented rate both as regards the portfolio investments that a deposit institution makes and as regards the buildings and capital equipment it operates as a producer of financial services.

When the effects of contemporary financial innovations are aggregated across society, much of the cost advantages that multipurpose financial firms realize is more apparent than real. Unintended subsidies flowing from the mispricing and overcoverage of risk and the overly cautious failure-resolution policies carried out by the federal deposit-insurance agencies lowers the costs of product-line and geographic market extension for individual firms. But it does so only by imposing unaccounted expense and unrecognized liabilities onto the deposit-insurance agencies and onto taxpayers and conservatively managed competitors who knowingly or unknowingly backstop the agencies' limited insurance reserves.

Maladapted pricing, coverage, and failure-resolution schemes for federal deposit insurance create incentives for depository institutions to reach out into new financial-services markets and for nondepository institutions to look for inventive ways of folding deposit-insurance guarantees into their operations. Given the vast (albeit unrecorded) size of these subsidies, it is unconscionable to maintain -- as several leading Administration officials regularly assert -- that the resulting fusion of financial product lines and geographic markets is a market solution and, therefore, an efficient allocation of resources. Until federal deposit insurers explicitly price such unregulated risks as those associated with borrower default, differences in asset and liability maturity, balance-sheet leverage, affiliated institutions, and technological obsolescence, no amount of tinkering with the frontiers of permissible activities for different types of institutions is going to secure a settled industry structure. On the other hand, any type of tinkering that increases differences in regulatory treatment for different types of firms or for substitute activities expands opportunities for organizational adaptations that serve in the long run to put even more pressure on the inherited system of deposit insurance.

Summary

Our panel has been invited here today to advise you about how best to pick through the catalogue of alternative reforms featured in S. 2134, S. 2181, and S. 1609. I cannot in conscience accept this narrow assignment. I feel much as a doctor might who is asked to advise a patient whether to take aspirin or tylenol to treat an operable cancer. The problem is that the very provisions of the three bills that would make the financial-services industry marginally more efficient would, for that very reason, make the weaknesses in the deposit-insurance easier to exploit. The most effective types of treatment are simply not on the agenda.

Ending, or at least curtailing, deposit-insurance subsidies to exotic forms of risk-taking is the regulatory action that would best serve the long-term interests of the general taxpayer, depository-institution competitors in the insurance, consumer-finance and securities industries, and even the bulk of the depository industry. Compared in importance to this reform, no other proposal comes even within sighting distance.

Politics as usual is to legislate only after a clear consensus for action has developed within the affected community. As compared to industry self-regulation, this propensity for delayed reaction is one of the great disadvantages of government enterprise. If deposit insurance had been organized as a governmentally monitored cooperative system of mutual guarantees, proactive pressures against risk subsidization would have been exercised long ago. No matter how wisely your committee picks and chooses among the more-limited structural reforms that form this morning's agenda, until the deposit-insurance system is fundamentally redesigned, the financial-services industry is going to confront you and your colleagues with one pressing problem after another.

Senator GORTON. Thank you.

Mr. Kaufman.

STATEMENT OF GEORGE KAUFMAN, PROFESSOR, COLLEGE OF BUSINESS ADMINISTRATION, LOYOLA UNIVERSITY, CHICAGO, ILL.

Mr. KAUFMAN. Thank you, Mr. Chairman. I am happy for the opportunity to present my views. I will highlight part of my prepared statement.

[Complete statement follows:]

3-5-84
Revised 3-16-84

FINANCIAL DEREGULATION AND PUBLIC POLICY

Prepared Statement to Committee on Banking, Housing, and Urban Affairs
U. S. Senate, Washington, D.C.
March 13, 1984

George G. Kaufman
(John F. Smith, Jr. Professor of Finance and Economics,
Loyola University of Chicago)

Deregulation of the financial system and in particular of commercial banking has been an ongoing process from the time that the combined effects of dramatic advances in telecommunication technology and sharp increases in the level and volatility of interest rates started to undermine the existing regulatory framework that emphasized safety and minimum competition, which had been in place more or less intact since the early days of the Great Depression.[1] Since the late 1970s, Congress has validated de jure many of the market induced changes, which represented de facto deregulation, particularly in the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Depository Institutions (Garn-St Germain) Act of 1982. These two acts led to the elimination of rate ceilings on time deposits and also expanded the lending authority of thrift institutions. The major remaining areas in which market forces are clashing with regulations in place are product and geographical market line restrictions for commercial banks and the prohibition against cash interest payments on demand deposits. The legislation before this Committee considers these issues as well as others. Because the specific bills are long, complex, and technical, I will limit my prepared comments to general underlying principles.

With respect to the prohibition on cash interest payments on demand deposits, I believe that its final removal is long overdue. Market forces have already removed it effectively for most household accounts through NOW and SNOW accounts and have made circumvention relatively easy for larger business corporations. Final removal should aid those depositors who are not yet able to circumvent the prohibition, without causing the institutions serious difficulties. True, as with any deregulation and change in general, some customers and/or banks, who had been subsidized by others, will be disadvantaged, but the average customer and, more importantly, the overall public welfare will benefit.

I am not equally supportive, however, of paying interest on bank reserves. It is a poor second-best solution. Determination of the correct interest rate to pay will involve the Federal Reserve in the same type of messy determinations as in correctly pricing its services to banks. A preferred solution is to eliminate legal reserve requirements altogether, although a standby arrangement may be kept for emergencies. Neither the original function of these requirements for safety nor the later function for monetary control is valid today, and little is gained by preserving the requirements just for the sake of tradition.[2]

The problems of changing the permissible product lines and geographical markets of commercial banks are closely tied to the problem of defining a commercial bank. The major constraints on commercial banks today arise from the Bank Holding Company Act. Institutions that are not defined as commercial banks do not come under the constraints of the Act and have far greater freedoms. "Nonbanks" are defined by the Act as any financial organization that does not (1) accept deposits legally withdrawable on demand and (2) make commercial loans as defined by the Board of Governors, which has primary responsibility for enforcing the provisions. "Nonbanks" are also less hampered by the Glass-Steagall and McFadden Acts. Indeed, some may branch nationwide and engage in full-service securities activities.

Institutions that offer both demand-like deposits and commercial-like loans are restricted to engaging in only basically similar types of activities and, in their main line of activity of direct deposit gathering and lending, basically only in their home state. Should commercial banks, however defined," be so restricted? The U.S. banking system is modelled in large measure after the British system, which separates commercial banking from most other financial activities and most nonfinancial or commercial activities. From the Civil War to the 1930s, larger U.S. banks expanded their activities beyond accepting deposits and making loans, particularly into underwriting and trading in securities. This was stopped by the Glass-Steagall Act for privately issued securities. Banks had not expanded into other areas as much, most likely because, until recently, the primitive state of communications and transportation made efficient management of highly diverse financial institutions difficult. Until 1956, however, there were relatively few legal constraints on bank expansion into other areas through the holding company format. The Bank Holding Company Act of 1956 separated multi-bank holding companies from nonbanking financial and commercial activities, and the 1970 amendments to the Act separated all banks from such activities except if they were viewed by the Board of Governors as incidental to banking and in the public interest. In recent years, ever increasing ways have been found to circumvent these restrictions.

Why do we need a special public policy towards combinations of commercial banks and nonbank activities? We generally do not impose similar blanket restrictions in other areas. If combinations of any activities are profitable and do not violate general anti-trust provisions, they are permitted to occur. If the combinations are not economically efficient, the marketplace will generally penalize them. But there is a belief that commercial banking is different. Combinations of banking and nonbank activities might create important problems of excessive concentration of power (economic, social, and/or political), undue risk of failure, conflicts of interest, and violations of equity and fairness. These problems have been discussed at length.[2] While hard evidence as to their validity is scarce, the potential damages are widely believed to be so great and adequate redress so difficult as to warrant great caution in removing the barriers. Nor is the evidence any stronger that such combinations would improve economic efficiency or welfare.

But in light of the machine-gun rapidity of today's events, cautious changes cannot mean no changes. The horses are escaping, and recapturing and restoring them to the existing barn will be next to impossible. The fundamental question to be answered for any policy for the future is which types of financial activities do we want to keep separate from other financial and nonfinancial activities. The institution providing these activities would be a "bank." Many believe that these activities are transactions accounts and commercial loans, and in yesterday's world it was easy to define a bank in these terms. But today almost anyone can offer these or almost indistinguishable services, so this definition is no longer workable. A remaining major distinguishing feature among institutions offering similar services, however, is federal deposit insurance.[3] Not only does this insurance increase the security of small depositors directly, but it indirectly protects large, technically uninsured depositors who know that large banks will not be permitted to fail with significant, if any, losses to them. Thus, for better or worse, federal deposit insurance is a clear-cut and workable peg on which to hang the definition of an institution whose powers to provide designated services are to be restricted. This definition is also favored both by the Federal Reserve and by the participants of the 1983 American Assembly Conference on the Future of American Financial Services Institutions.

As is, defining a bank for Bank Holding Company Act purposes by use of federal deposit insurance would encompass many institutions not covered by the current definition, including thrift institutions and some industrial banks. These institutions would have a choice of retaining federal deposit insurance[4] and surrendering their nonpermitted activities (or the ability to add further nonpermitted activities) or engaging in any activities they wish but surrendering their federal deposit insurance. However, the type and number of institutions covered may be modified by restricting the insured deposits definition to only particular types of deposits, such as transactions deposits, or to more than a minimum proportion of such deposits, such as no more than X percent of deposits in transactions deposits. The bills before this Committee contain such provisions for thrift-type institutions (qualified thrift lenders) and consumer banks. The exceptions are justified on the basis that the problems of conflicts of interest and excessive concentration will be relatively small. Balanced against this, however, are questions of equity among competitors and ability to circumvent the regulations. I would urge caution on any and all exceptions.

The second issue for this or any other definition of a bank is what powers to permit. The greater the permitted powers, the greater are the potential dangers enumerated earlier, but the lesser are the incentives to circumvent the definition. The bills before this Committee propose broader powers than currently permitted, particularly in other financial activities. I favor such a change subject to a number of restrictions: 1) that the need for quick and effective enforcement of anti-trust and anti-tying provisions be reaffirmed, although I am not sure that numerical aggregate concentration limits, such as in S2181, are the most appropriate way to go and I would make the provisions apply to all institutions, not just banks; 2) that permissible financial activities do not include acting as principals in underwriting or trading of corporate securities, including commercial paper, and developing real estate (which is not a financial activity and should be subject to the same restrictions as other nonfinancial activities); and 3) that dealing in mutual funds be restricted to funds in which equity and debt ownership are sufficiently diversified to prevent bank control, e.g., a provision that holdings of the stock and debt securities of any one firm or issuer, other than the U.S. government, account for no more than, say, 5 percent of the issuer's outstanding securities.[4] For the sake of equity, I would also remove the distinction between Federal Reserve member and nonmember banks and between banks and thrift institutions for securities powers under the Glass-Steagall Act.

For institutions defined as banks under the Bank Holding Company Act, I would permit full service interstate banking either through branching or holding company affiliation, except in states which chose to prohibit both entry by out-of-state banks and out-of-state offices of in-state banks. This would apply to national banks as well as to state chartered banks.

The above recommendations leave me somewhat unhappy and I assume will leave others equally or more unhappy. But I believe that this is in the nature of the beast. Although considered, they are not always based on the most rigorous economic analysis. Regulation grew unintentionally piecemeal like topsy, and there is no reason to believe that deregulation will proceed any differently. However, if we do our homework carefully as to what it is that we fear with respect to concentration, conflicts, and risk, we may still be able to construct a more rational and longer-lasting framework.

Footnotes

1. The underlying effects have been discussed in George Kaufman, Larry Mote and Harvey Rosenblum, "Implications of Deregulation for Product Lines and Geographical Markets of Financial Institutions," Staff Memoranda, 82-2 (Federal Reserve Bank of Chicago), 1982; __________, "The Future of Commercial Banks in the Financial Services Industry," Staff Memoranda, 83-5 (Federal Reserve Bank of Chicago), 1983; and __________, "Consequences of Deregulation for Commercial Banking," Staff Memoranda, 84-3 (Federal Reserve Bank of Chicago), 1984.

2. Marvin Goodfriend and Monica Hargraves, "A Historical Assessment of the Rationales and Functions of Reserve Requirements," Economic Review (Federal Reserve Bank of Richmond), March/April 1983.

3. Federal deposit insurance is unique for two reasons. One, unlike other types of insurance, it is not priced on the basis of the risk assumed by the buyer. In addition, it is likely that overall premiums are too low, particularly for thrift institutions, and the insurance represents a subsidy to the industry as a whole. Two, there is no fear that insured as well as most uninsured deposit losses will not be paid immediately and in full. That is, there is no fear of the solvency of the insurer regardless of how large the potential losses.

4. It is of interest to note that nonbank financial officers are not overly enthusiastic about permitting banks to engage in nonfinancial business or in underwriting corporate securities. Karen Slater, "Business Likes Bank Deregulation But Support Is Weaker on Specific Proposals," American Banker, October 8, 1983 and "Banking and Commerce Separation Backed by Most Financial Officers," American Banker, October 9, 1983.

Senator **GORTON**. Thank you, Mr. Kaufman.

Mr. Lovett.

STATEMENT OF WILLIAM A. LOVETT, PROFESSOR OF LAW AND ECONOMICS, TULANE UNIVERSITY SCHOOL OF LAW, NEW ORLEANS, LA.

Mr. **LOVETT**. Mr. Chairman and members of the committee, thank you for this opportunity to testify with respect to the pending legislation. Since you have the full text of the statement with the appendix materials attached, I will merely add some things and summarize.

I might comment that major portions of my new book "Banking and Financial Institutions Law," published by West Publishing Co., which came out in January 1984 are directly focused on the boundary controversies and restructuring issues that this committee is dealing with this year and will probably have to deal with for some years in the future. I cover those issues in great historical depth with considerable economic data.

Broadly speaking, there are two fundamental purposes behind banking legislation: To distribute financial power in a Federal democracy, a network of 50 States, and communities all over the country; and second, to reasonably regulate risk and somehow provide insurance for some core of deposits.

On the whole, unlike many of the preceding panelists, I believe most of our accumulated banking regulation for the last generation has been highly successful. It should not be discarded lightly or dismantled in a hasty, unwise fashion.

The most serious blunder we made in this regulation experience was clearly regulation Q and the attempt since the late 1960's, off and on, to artificially keep interest rates down.

Fortunately, with painful effort and considerable gradual legislation we have eliminated that problem and in the wake of all that we have a much improved and somewhat more competitive financial market today.

Now in the current situation we face three major financial problems. They are closely interrelated. The international debt rescheduling crisis, excessive budget deficit, and the boundary fight between large and small financial institutions, thrifts, securities firms, and insurance companies.

Unfortunately, the international debt crisis is more serious than most people realize. In my judgment, this LDC debt crisis could last another 5 to 10 years, perhaps longer, depending partly on the speed with which the United States and other major industrial countries eliminate their major budget deficits.

[Complete statement follows:]

Statement of Dr. William A. Lovett
Professor of Law and Economics
Tulane Law School, New Orleans, Louisiana 70118
March 13, 1984

Mr. Chairman and Members of the Committee: Thank you for this opportunity to testify on behalf of the pending banking legislation. I have been active in teaching, research, and scholarship in banking and financial institutions policy for the last nine years, and I have been involved in antitrust and regulatory matters more generally for the last 24 years. I have attached copies of the most relevant sections of my recent publications as an appendix to this statement. In these remarks I will focus mainly upon the current financial market restructuring controversy, or the Great Financial Boundary Fight of the 1980's.

Our nation faces three major financial problems: (1) the international debt overload and rescheduling crisis; (2) excessive budget deficits and conflicts on spending and taxes; and (3) a controversy between large and small financial institutions around the country over boundaries between banks, thrifts, securities firms, and insurance companies. These problems are inter-related.

The international debt overload and rescheduling crisis is more serious than most people realize. The Less Developed Countries (LDC's) have more than $800 billion in foreign debt, at least half owed to international banks. U.S. multinational banks have the largest chunk of these loans (more than $175 billion), an amount substantially larger than the net capital of our biggest banks. This exposure is dangerous to banking solvency in the U.S., and a chain reaction of LDC defaults could reverse economic recovery in many countries. Widespread defaults would mean a dreary mess for the U.S. government. We might be forced to bail out the big banks, and this would involve creating more money with more inflation, or increasing government debts and deficits, or enlarging tax revenues substantially to cover these losses (in some combination or other).

Unfortunately, 20-30 countries are in the debt overload predicament. Their cost of debt servicing substantially exceeds what these economies can bear comfortably. As long as world interest rates remain elevated and international recovery remains slow, their squeeze continues. In many of these nations deficits are as bad or worse as the U.S., with serious leftist and Marxist pressures that make fiscal responsibility difficult. Discipline will not come easily.

In my sabbatical travels to East and Southeast Asia this fall, and in conversations and seminars at the American Economics Association Convention in San Francisco, December 27-30, 1983, concerning Latin America, the Caribbean, and Africa, I learned more about the buildup of resistance to paying off these international debt obligations. I encountered the following argument frequently from Third World economists in private conversations: "Well, much of the money from these international loans was wasted in boondoggles and corruption; some of it was recycled back into secret bank accounts in tax havens. We don't think our people should have to pay it all back. And interest rates must be greatly reduced anyway." An interesting argument! Political opportunists in the Third World can use this "scapegoat" reasoning to destabilize regimes that employ painful budget discipline and high interest rates to comply with stringent IMF conditionality requirements.

Sadly, in my judgment, the LDC debt crisis could last another 5-10 years, depending partly on the speed with which the United States and other major industrial countries eliminate their own budget deficits. The longer we take to achieve our budget discipline, with continued high interest rates in the interim, the period of rescheduling crisis and strain for U.S. multinational banks will be lengthened accordingly. So the world debt crisis, major U.S. bank vulnerability, and excessive budget deficits are tragically linked. All things considered, it seems likely that a substantial part of the LDC debt load may have to be written off as losses, though this probably can be done on a gradual basis with skillful regulatory supervision.

What are the implications for restructuring financial markets and their regulation? The main conclusions to be drawn are the following: (1) United States bank regulators, supervision, and Congress must be more vigilant than ever. We are living on the edge of a major financial disruption for ourselves and the world economy, a period of strain that could last for 5-10 years. (2) We should avoid radical, rapid restructuring of financial markets, and prevent a stampede of destabilizing mergers. These markets already have suffered major strains from EFT and computer technology, increased competition for deposits and higher interest rates, and for savings institutions, the burden of older, low interest mortgage portfolios. Happily, few institutions have failed so far, and disruption to depositors, the public, and our economy has been kept to a minimum. (3) We should continue a recent pattern of gradual, deliberate, and carefully discussed progress in allowing more competition for financial markets. Major gains for the public interest have been made with incremental, methodical deregulation, and responsible regulatory supervision. Let´s not throw away accumulated success, and risk upsetting an already shaky world financial situation.

We should all recognize that America´s decentralized banking and financial institution markets have been quite successful historically. Our decentralized, "people oriented" system of 14,500 banks, 4,000 savings institutions, 20,000 credit unions, thousands of securities firms, and thousands of insurance companies has been healthy and reasonably competitive. This financial system has been a foundation of decentralized capitalism in our federal democracy. It helps promote social mobility, political pluralism, and economic development and local self-respect all over the country, in all states, most cities and towns.

We have learned, however, through many financial panics and experience with fraudulent operators, that sensible regulation has been necessary. But our present financial market regulatory system has been remarkably successful since the Great Depression,

Table 1

Aggregate Concentration
Banks and Other Depositary Institutions
Total Deposits and Assets ($ billions)

	Consolidated[1] Deposits	% of Deposits	Consolidated[1] Assets	% of Assets
Commercial Banks	1,409.7		1,915.9	
Bank America	94.3	6.7%	122.2	6.8%[2]
Citicorp	76.5	12.1%[3]	130.0	13.2%[3]
Chase Manhattan	56.9		80.9	
Manufacturer's Hanover	43.9		64.2	
J.P. Morgan	37.9		58.9	
First Interstate	30.5		40.9	
Continental Illinois	28.2		42.9	
Chemical N.Y.	27.9		48.3	
First Chicago	27.4		35.9	
Security Pacific	25.8		37.0	
Top 10 Commercial Banks	449.3	31.9%	661.2	34.5%
Top 20 Commercial Banks	604.7	42.9%	885.4	46.2%
Top 50 Commercial Banks	791.8	56.2%	1,145.1	59.8%
Remaining 14,500 Commercial Banks	617.9	43.8%	770.8	40.2%
Savings and Loan Associations [3,833 institutions]	603.4			
Mutual Savings Banks [424 institutions]	207.9			
Credit Unions [20,000 institutions]	80.8			
Agencies and Branches of Foreign Banks and Edge and Agreement Corporations	36.3			
Total All Deposits	2,338.1			

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[1] Consolidated deposits and assets for top 50 U.S. banks. 9/83. Data from Association of Bank Holding Companies.

[2] Citicorp 6.8% is asset leader. [3] Top 2 banks.

NOTE - The top 20 commercial banks have the large majority of international assets, or $265 billion of $317 billion (or 84 percent).

(Sources: Federal Reserve Board; Council of Economic Advisors; Association of Bank Holding Companies.)

and its subsequent refinements have been mostly sensible, pragmatic responses to minor difficulties. I have continuing confidence in this system, if we keep it largely intact, stable, and reliable.

Our decentralized financial system combines ample institutions of great size, i.e , multinational banks, nationwide securities firms, and large insurance companies. These big firms actually account for the larger part of nationwide banking, securities, and insurance business and assets. (For example, commercial banking is already concentrated, with the top 20 banks having 46.2 percent of total assets, and the top 50 banks 59.8 percent. See Table 1.) But smaller institutions provide good service, valuable competition, and local financial talent all over the country, so that no area needs to feel oppressed by distant and unresponsive financial centers. This system has been nicely adapted to American democracy, and yet, it is highly efficient as a capital market, electronically well-linked all over the country, and facilitates world financial transactions.

With respect to the current boundary fights among banks and financial institutions, we should move very slowly in broadening their interpenetrations. McFadden-Douglas interstate banking boundaries should be retained. Modest experimentation among some states in allowing limited interstate banking is acceptable, so long as each state and its financial institutions decide what is best in their areas to meet local needs. The current, gradual movement toward some regionally balanced growth makes excellent sense for most states, and the large majority of our people. The

Independent Bankers Association of America is right in defending our network of locally owned banks. With so many industrial plants owned by conglomerates in distant cities, it is vital to keep most of our banks locally owned and managed. And most smaller states are quite right and have a legitimate interest in wanting to prevent their banks from being taken over wholesale by giant banks from a small handfull of big banking center states. Decentralized banking is good for America, it is healthy in a federal society, and we should be enthusiastic about maintaining it with McFadden-Douglas traditions.

The Glass-Steagall Wall still is justified in separating insured depository institutions, their fiduciary responsibilities, and the marketing and sales efforts for securities. Nonetheless, increased competition between banks, thrifts, and securities firms has been beneficial to the public. Money market funds and the breakdown of restrictive interest rate regulation (Reg. Q) were the result of this rivalry. Without this inter-industry competition we would probably be suffering Reg. Q limits today, and less attractive interest rates for smaller depositors.

Likewise, rivalry between separate insurance companies, securities firms, and depository institutions is healthy. The pension and retirement account fields have a great deal of competition already. Somewhat more rivalry might be allowed for insurance policies, but its increase should be gradual and not highly disruptive. We should follow the pattern of gradual change with NOW accounts and money market accounts during the last 12 years, and allow increased penetration of insurance markets incrementally.

Finally, with respect to merger activity across financial industry lines, we should move slowly and carefully. We have been quite cautious and slow with bank into thrift mergers, and properly so; we accord them only a low priority, and that mainly for troubled institutions. The same logic holds for mergers between banks and insurance companies; it would be better to allow limited rivalry in new products and services, and permit mergers mainly for troubled institutions. The same logic holds for mergers between banks and insurance companies; it would be better to allow limited rivalry in new products and services, and permit mergers mainly for troubled institutions. As between depositary institutions and securities firms there is a proper separation of function under Glass-Steagall, and this should be retained under the law.

I realize a few major banks and financial institutions are pressing hard for a complete breakdown of boundaries and unlimited merger activity. Some of these happen to be among our most vulnerable multinational banks, which should raise serious questions about selfish motivations.1/ But there is absolutely no need to allow such a drastic restructuring of American

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1/We should be developing contingency plans for bailout mergers and/or long term capital loans to Citicorp and a few other multinational banks that are most vulnerable to LDC loan defaults. But the distress of these few institutions, brought on partly by their own failure to set adequate limits on LDC debt, is no justification for destroying the decentralized U.S. banking and financial system.

financial markets. Computer technology and EFT is so powerful that it can adapt comfortably to any conceivable market structure among banks and financial institutions, so that economies of scale do not require massive increases in concentration. Our present system works well, and has shown ample flexibility over time. It has been well regulated, for the most part, at least in the last generation.

If we should allow unrestricted merger activity now among banks, thrifts, insurance companies, and securities firms, there is danger of a destabilizing scramble for financial power, leverage, and fast-buck promoter profits. We could see a chain reaction of excessive financial merger activity. Responsible supervision of banks and other financial institutions could be seriously weakened in a period of severe international strain. Competition among financial institutions would be reduced, in many ways irrevocably. We would throw away the proven benefits of a highly decentralized financial network, with fairly easy entry. All this would be an irresponsible and foolish blunder. It would risk needlessly disruptive consequences, cause many human and financial losses, and weaken economic recovery for the United States and free world generally. I remain confident that Congress should avoid such costly adventures, and stick to our recent pattern of slow, careful evolution in financial markets, maintaining firm supervision and comprehensive accountability in the public interest.

Excerpted from William A. Lovett, Banking and Financial Institutions Law in a Nutshell, West Publishing Co., St. Paul, MN, 1984.

Table VIII-1
U.S. Financial Intermediary Assets, 1929–1981
(billions of dollars)

	1929	1960	1981
Commercial Banks [1]	$ 71.5	$257.6	$1,808.7
Mutual Savings Banks	9.9	40.6	175.6
Savings and Loan Associations	8.7	71.5	663.8
Credit Unions	negligible	5.7	77.7
Money Market Funds	———	———	181.9
Investment Companies (including mutual funds)	small	17.0	55.2
Life Insurance Companies	17.5	119.6	526.0
Property-Liability Insurance Companies	4.0(e)	32.0	212.0
Private Pension Funds	modest	38.1	410.9
Pension Funds (state and local government)	modest	19.7	226.2
	$113.0(e)	$601.8	$4,338.0

Gross National Product, Government Spending, Surplus and Deficits, 1929–1982
(billions of dollars)

	1929	1960	1982
Gross National Product	$103.4	$506.5	[illegible]
Total Government Spending	10.3	136.5	[illegible]
Government Surplus or Deficit	+ 1.0	+ 3.1	−116.1
Federal Surplus or Deficit	+ 1.2	+ 3.0	−147.9
State and Local Surplus or Deficit	− .2	+ .1	+ 31.9

SOURCES: *Statistical Abstract of the U.S. 1982–83*, Census Bureau., U.S. Department of Commerce, *Economic Report of the President*, February, 1983; and sources listed for Tables II–1, III–1, IV–1, V–1, VI–1 and VII–1 (supra).

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[1] Data for 1981 includes international banking.

Chart VIII–1
Established Market Participation Among Financial Institutions

		Market Stuctures
I. **Deposit Taking Institutions** COMMERCIAL BANKS (Generally restricted to single states under established law)		Competitive national banking market serves large customers Local oligopolies serve small business and families
Thrifts— MSB's S&L's	Expanding to commercial banking	Competitive alternatives to commercial banking, with special role in housing finance
Credit Unions	More limited services, mostly for employee members	Limited competition for banks, other savings institutions
II. **Securities Marketing Institutions** **Brokerage Firms** **Mutual Funds & Investment Co's** **Underwriters**	Often integrated, national enterprises	Loose oligopoly of nationwide firms, with competitive fringe of smaller and local firms
Issuers (Corporations, Partnerships)		Includes all enterprises issu[illegible]
III. Insurance Companies Life, Health Insurers		Loose oligopolies of nationwide firms, with smaller and local firms as competitive fringe
Property, Liability Insurers		Loose oligopolies of nationwide firms, with smaller and local firms as competitive fringe
IV. **Pension Fund Managers** Commercial Banks Insurance Companies Labor or Professional Organizations		Loose oligopolies of nationwide firms, with smaller and local firms as competitive fringe

V. **Social Insurance System** Federal Social Security Other Federal Insurance Programs	Unitary nationwide system
State and Local Government Social Insurance Activities	State (or Municipal) programs

Chart VIII-2
Major Restructuring of Market Participation Among Financial Institutions

		Market Stuctures
I. **Deposit Taking Institutions** COMMERCIAL BANKS (Nationwide enterprises with unrestricted branching and diversification activities)		Nationwide oligopoly of conglomerates, with some local banks surviving as limited competition
Thrifts— MSB's S&L's	Close to commercial banks, but usually smaller	Limited competition, mainly in local areas
Credit Unions	More limited services, mainly for employee members	Limited local competition
II. **Securities Marketing Institutions**		
Brokerage Firms Mutual Funds & Investment Co's Underwriters	Nationwide diversification allowed	Nationwide oligopoly of financial conglomerates, and weak competitive fringe of smaller firms
Issuers (Corporations, Partnerships)		Closer links between major financial conglomerates and leading corporations
III. **Insurance Companies** Life, Health Insurers Property, Liability insurers		Nationwide oligopoly of financial conglomerates, and weak competitive fringe of smaller firms

IV. **Pension Fund Managers** Commercial Banks Insurance Companies Labor or Professional Organizations	Nationwide oligopoly of financial conglomerates, and weak competitive fringe of smaller firms
V. **Social Insurance System** Federal Social Security Other Federal Insurance Programs	Unitary nationwide system
State and Local Government Social Insurance Activities	State (or Municipal) programs

Senator GORTON. Mr. Phillips.

STATEMENT OF ALMARIN PHILLIPS, PROFESSOR, WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA.

Mr. PHILLIPS. Thank you, Mr. Chairman. You and, I think, Senator Gorton especially, will be sorry to hear that I'm resisting the urge to stand on only my prepared comments. I'm resisting only because I feel that the topic covered by those comments is important.

PAYMENT OF INTEREST ON RESERVES

My testimony relates to title IV of Senator Garn's bill, S. 2181, where it is proposed that the Federal Reserve be required to pay interest on certain classes of reserve balances. As now stated, that requirement would mandate that the rate paid be equal to the earnings on the securities portfolio of the Federal Reserve System during the month in question.

Mr. Chairman and members of the committee, the question of interest on reserves has been raised by commentators and discussed in hearings such as these over a number of years. In my view, the payment of interest on reserves, along with the abolition of the prohibition of interest on demand deposits, and careful consideration of the insurance reforms suggested by Professor Kane should be priority items for this committee and the entire Congress.

The problems I have, Mr. Chairman, with the provisions with the paying of interest on reserves are twofold. The first is that the proposal doesn't cover all reserves. Even more important, however, is the proposed requirement that the payments be made at rates determined by Fed earnings. I think that any requirement of that sort—as my colleague Professor Kaufman has noted—raises questions of accounting—how does one really determine what those earnings are? But more importantly, it would preclude the possibility of using interest payments on reserve balances as an important, new monetary policy tool of monetary policy. My prepared remarks cover that in some detail.

I note rather parenthetically that a major obstacle to legislation along the lines suggested by your proposals, Mr. Chairman, has been the Treasury. That Department continually notes that the earnings of the Federal Reserve under current legislation are in large measure passed on to Treasury. My understanding is that those amount to something on the order of $15 billion currently and I can understand why one might worry about that.

The CHAIRMAN. That's $15 billion over and above the Fed's operating expenses.

Mr. PHILLIPS. That's correct. I say, not entirely facetiously, that I have a bit of difficulty understanding why the same individuals who seem quite unconcerned with the deficit of $150 billion or $250 billion somehow or other are so hung up on this $15 billion. Returning to my primary thesis, however, the truth of the matter is, Mr. Chairman, that it is not a kind of a tax that can prevail for the long term in any case. Reserve requirements select particular financial institutions and, by having a zero interest rate on mandated reserves, inappropriately and discriminately tax those institutions. The new payments technology, I believe, will not allow that to continue in the future in any case.

MONETARY POLICY IMPLICATIONS

Let me very quickly, however, note the monetary policy implications of interest on reserves. Suppose that tomorrow morning there were a requirement that the Federal Reserve pay interest on reserve balances and that the rate was high enough so that at least some institutions felt that reserves balances were an attractive asset in their portfolios. In those circumstances, the interest on reserves would mean that institutions holding reserves would compare those with other assets which they might be holding, other earning assets. The higher the rate the Fed establishes on reserve balances, the more institutions would be inclined to substitute reserves as earning assets for other types of instruments.

That means that an increase in the rate paid by the Fed would create, if you will, selling pressure on other bank assets. That selling pressure would tend to lower the market prices for the other assets, increasing their yields. In brief, sir, that means that as the Fed increases the rate it pays, that policy and those rates will get transmitted almost instantaneously into other marketable assets, making their yields increase in parallel with the Fed's rates on reserves.

On page 7 and at the top of page 8 of my prepared statement, I note very briefly the monetary policy implications. I take the supposition that the Fed, empowered to pay interest on Fed reserves, decides that current rates are too high or that they are increasing too rapidly. With the present policy tools all the Fed can do is to relax its quantitative monetary controls. Curiously, with today's Fed watchers on Wall Street, the immediate effect of that action might well be to raise interest rates rather than to lower them. With a flexible and discretionary ability to lower rates on reserves, the Fed could lower market rates—or cause them to rise less rapidly—without resort to quantitative controls.

I urge your very careful reconsideration of your proposal for requiring interest on reserves, along with those concerning the prohibition of interest in demand deposits and deposit insurance.

[Complete statement follows:]

STATEMENT OF ALMARIN PHILLIPS, HOWER
PROFESSOR OF PUBLIC POLICY, WHARTON SCHOOL,
UNIVERSITY OF PENNSYLVANIA
to the
COMMITTEE ON BANKING, HOUSING AND URBAN
AFFAIRS, UNITED STATES SENATE
MARCH 13, 1984

Mr. Chairman, I appreciate your invitation to appear on this panel. The rapidly changing markets for financial services present challenging legislative, regulatory and business problems. The Bills now before the Committee, S.2134 and S.2181, reflect these problems. You and the other members of the Committee deserve much credit for the enormous amounts of time and energy you have spent on formulating policy in this area.

My prepared comments relate primarily to the provisions of Title IV of S.2181. It is therein proposed that the Federal Reserve pay interest monthly on reserves held at Federal Reserve Banks by various classes of deposit institutions against money market deposit accounts, super NOW accounts and any new transaction accounts authorized by the Depository Institutions Deregulation Committee. As proposed, the Federal Reserve would be required to pay interest on such balances "at the rate earned on the securities portfolio of the Federal Reserve System during that month."

Except for the possibility of similar interest payments on the "supplemental reserves" defined under the Depository Institutions Deregulation and Monetary Control Act of 1980, present law does not provide for the payment of interest on balances held by financial institutions at the Federal Reserve. Numerous commentators have over the years urged payment of interest on reserve balances. Indeed, along with others, I present testimony pertaining to such payments on May 14, 1979, in hearings of this Committee on the proposed Monetary Policy Improvement Act of 1979. The Final Report of the National Commission on Electronic Funds Transfer also recommended payment of interest on reserves.

Mr. Chairman, it is vital to recognize that the primary reason for permitting the payment of interest on reserves relates to monetary policy. It is true that in some respects the depository institutions are disadvantaged in competition with others that are not required to keep non-interest bearing reserves; that may be an ancillary reason for requiring that the Federal Reserve pay interest on balances held against the selected deposit liabilities subject to such competition. But to repeat, it is not the competition issue that provides the basic reason the Federal Reserve should pay interest on reserves. It is difficult now and it will become increasingly more difficult to have effective monetary policy without there being interest payments on reserves.

It is also true, Mr. Chairman, that a major obstacle to legislation requiring interest payments on reserve balances has been the effects of these payments on receipts of the Treasury. Under current law, the earnings of the Federal Reserve are in large measure passed through to the Treasury. With the imposition of interest payments on its liabilities, the earnings of the System and, hence, Treasury receipts would be materially reduced. In the interest of brevity, I will not dwell on this aspect of the issue except to say that -- with new market freedoms and the continuing advances in technology -- the selective "taxation" of the deposit institutions through mandated, non-interest bearing reserve requirements will soon have to be corrected in any case.

In short, then, the proposal for payment of interest on reserves is a step in the right direction, Mr. Chairman. Unfortunately, however, there are fundamental shortcomings in S.2181 with respect to the criteria for determining the rate at which payments are to be made and with respect to the restricted classes of reserve balances on which interest is to be earned. These shortcomings must be corrected to prevent what could be quite counter-productive results.

In the aggregate, the total amount of reserves held by the Federal Reserve System is controlled by the System. While individual institutions can and do increase or decrease their reserve holdings by selling or buying other assets and by borrowing or lending reserve balances, any action to change the amount of reserves by one institution has equivalent and offsetting effects on the reserves of other institutions. In the absence of purposeful System operations to the contrary, and ignoring certain other exogenous factors that affect reserves, the amount of total reserves in the system is fixed irrespective of the demand for reserves by member institutions.

If the Federal Reserve is required to pay interest on reserves, the later will become a more attractive asset. Following normal demand behavior, the deposit financial institutions will become more willing to hold assets in the form of Federal Reserve balances the higher is the interest rate paid on those balances. Thus, any time the Federal Reserve increased for any reason the rate paid on reserves, institutions would, if other rates are assumed for the moment to be given, wish to hold more reserves. The market behavior reflected by this increased willingness to hold (increased demand for) reserves would entail, of course, a decreased willingness to hold other interest bearing assets at the then prevailing rates. These other assets would then be subject to sales pressure, lowering their market prices and, concommitantly, increasing their market yields. That is, the increase in the rate paid by the Federal Reserve on reserve balances would be virtually instantaneously transmitted to increases in the market rates on all other interest bearing assets. Decreases in the rate paid by the Federal Reserve on reserve balances would similarly cause virtually instantaneous decreases in the yield on other assets.

That these effects do not now show up in the market is due solely to the fact that, for the vast preponderance of deposit institutions, required reserves are in excess of the amount the institutions would voluntarily hold with the current zero rate of interest on reserve balances. But if positive rates of return on reserves are realized, some institutions will find that the mandated levels of reserves are less than they would voluntarily hold. The higher is the rate paid on reserves relative to the market rates on other assets, the greater is the extent to which this is the case.

Consider this in another way. Suppose the Federal Reserve were suddenly required by law to pay a rate on reserve balances equal to, say, the 90-day Treasury bill rate. Suppose that on the first day the Federal Reserve announces that it will pay, beginning the next day, the rate on bills existing on that first day. Reserve holding institutions would, it is likely, prefer to hold a smaller portion of their assets in 90-day Treasuries and more of their assets as interest bearing reserves. Yet the total outstandings of 90-day Treasuries and the total of reserve balances will be unaffected in the short run by such a change in portfolio preferences. What one institution gains in reserves (and loses in Treasuries) by its operations will be offset by decreases in the reserves of another (and by increases in someone else's holdings of Treasuries).

What would happen -- and it would happen at once -- is that the yield on Treasury bills would rise, thus increasing the target rate on reserve balances the Federal Reserve would have to announce the next day! Depending on factors far too complex to analyze here, the consequent changes in market rates might not even converge on a finite upper limit!

Under no circumstances, Mr. Chairman, should the Federal Reserve be obligated to pay a rate on reserve balances -- even on a small portion of total reserve balances --

that is tied to any market rate. Market rates will of necessity be affected by the rate paid by the Federal Reserve and only the market can establish an equilibrium relationship between the rate paid on reserves and market rates in general. Because reserve balances, like Treasury bills, are essentially riskless with respect to default and because reserve balances, unlike other assets, are used directly for clearing, these balances are likely to be attractive assets when interest is paid on them. One might anticipate a rate on reserves in equilibrium that is lower than the rate on other marketable securities and, indeed, lower than that on Federal Reserve earnings.

It is the very fact of these sensitive market interrelationships that makes payment of interest on reserves so attractive as a discretionary tool of monetary policy. Take another illustration. Suppose that the Federal Reserve, empowered to pay interest on deposit reserves, feels that current market rates are, say, too high (or increasing too rapidly). With present policy tools, all it can do is to relax its quantitative monetary controls and -- curiously -- the immediate effect of that action might well be to raise rates further. With authority to pay interest on reserves, however, the Federal Reserve has another tool. It can simply lower (or increase less rapidly) the rate paid on reserves.

By the market mechanisms described previously, the effect of such a policy action would be to lower (or cause to raise less rapidly) the yields on interest bearing, marketable instruments generally. The Federal Reserve could reach particular interest rate objectives without resort to or reliance on quantitative monetary policy instruments. A better way of stating this is that the central bank would have at its disposal both quantitative and interest rate tools that might be used in efficacious combination.

Mr. Chairman, the provisions of Title IV of S.2181 must be re-thought. There are some grave problems inherent in them as they now exist. At the same time, Mr. Chairman, these provisions contain the essence of what could become legislation of profound importance. Combined with the provisions of Title VII of S.2181, which would permit payment of interest on demand deposits, the truly necessary ingredients for a monetary system that comports with the technologies of the coming decades would be in place.

Thank you again.

M3/Q

The CHAIRMAN. Thank you. Gentlemen, may I thank all of you and apologize for not being here for all of your testimony. I'm sure that you're well aware that there is a far bigger problem than the specifics of the banking industry we're dealing with today, and that is the budget and the deficits, and I have been involved in a series of meetings in the last 2 or 3 weeks trying to resolve that and have been called on short notice—and one of them was this morning. So I appreciate very much Senator Gorton taking over for me so I could attend those meetings. He's a valuable member of this committee and has contributed greatly to it in the relatively brief time he's been a member. So I'm sure you were in good hands and I apologize for not being here personally.

Mr. Kane, on the initial page of your statement, you say:

> Unlike tax-reform legislation, successive financial-reform bills are intended to provide a lasting solution to the problems they address. When "permanent" solutions must be significantly amended within 2 years of their enactment, it should be clear that the solution team's conception of the underlying problem neglects one or more fundamental elements.

NO PERMANENT OR LONG-LASTING SOLUTIONS

As one who has been somewhat involved in the process, I'd like you to know that there never has been any intention that these are permanent or long-lasting solutions. They are only a part of a continuing process that I felt Congress had neglected for a long, long time, with piecemeal bits of legislation, emergency pieces of legislation, and an attempt to start a process a few years ago to get Congress to act. In fact, I made the comment many times about Garn-St Germain when people talk about it being a lasting piece of legislation—I certainly hope not—I certainly hope there's not a banking committee chairman sitting here 50 years from now discussing Garn-St Germain. I hope it is totally and completely forgotten. As we are discussing Glass-Steagall, McFadden, and a lot of old laws, I see this as a continuing process and it must be because the marketplace is a continuing process. It is changing and changing rapidly.

So certainly there is no intent that I'm aware of that the 1980's act determined a lasting solution. Certainly in my legislation 2 years ago that was not the intent. As a matter of fact, I intended a much bigger chunk at that time. So this is not really amending what has gone before. It's addressing some things, for example, municipal revenue bonds and money market mutual funds, which were a title in the original S. 1720 which were not able to pass and an issue that was, as a matter of fact, revenue bonds had passed the Senate twice back in 1975 and 1976.

So I understand the rest of your testimony. I certainly wanted to make sure that you understood that at least there was no intent on my part—and I've never heard anybody as even state it in this way, that these were intended to be lasting or permanent solutions. I don't think that's possible. I think if Congress acts responsibly there will be legislation almost continually with every new Congress if we are able to keep up with the innovations of the marketplace rather than get way, way behind.

Would you like to respond?

Mr. KANE. Mr. Chairman, your own insight into the legislative process and regulatee reactions goes without saying. The empty seats around you remind me that it is usually the people who don't attend church services who truly need the sermons.

However, I think it is fair to say that the regulatory strategies adopted during the deliberations leading up to the 1980 act were shortsighted and narrowly conceived. Deregulating deposit rates and diversifying thrift institution powers were promoted as a long-run solution to the problem of growing thrift institution insolvency without due consideration of how tax subsidies tied to mortgage lending activity and deposit insurance subsidies to risk taking would undermine this strategy. Similarly, extending Federal Reserve requirements to nonmember deposit institutions transformed rather than solved the Fed's longstanding jurisdictional problem. To gain a greater purchase on the causes of these problems, legislation would have had to deal with more fundamental issues, particularly with incentives established by current policies for deposit insurance pricing, coverage, and failure resolution.

The CHAIRMAN. I just wanted to make clear that certainly I think this is an ongoing process and none of these things are permanent or even very longlasting. At least I do not think they should be. But I have been accused of a lot of things—longsighted, shortsighted, no sight, stupidity—after all the years I've spent in public office, there isn't anything I haven't been called, so I didn't take it that way at all and if you meant it that way it floats off me anyway. It's kind of like off a duck's back.

Mr. Lovett, you mentioned very carefully in your testimony, and I quote, "slow, gradual, methodical, careful, thoughtful," and I understand what you're saying, but that marketplace is not standing still and these, as I've just said, are issues—some of them have been kicking around for a long, long time before I ever became a Senator. How do I interpret your testimony—what do you mean by slow and gradual? That means nothing this year, or nothing next year? Do we just sit and let the marketplace roll along? There will be more and more State legislatures acting if we do not come to grips with setting some national policy and making some national decisions.

I'm sure you're well aware of the latest New York State Commission's recommendations for that State. You've had many other legislatures who are getting involved in the process.

Do you think we have time to be as slow and deliberate and careful as you suggest in your testimony?

TIME TO BE SLOW, DELIBERATE, AND CAREFUL

Mr. LOVETT. Yes; I do, Senator. I think the process, for example, of State-by-State broadening of access to out-of-State banks is a sensible way for the various States to deal with a fundamental threat to their interests, which is that their banking systems might be taken over quickly and helter-skelter by a rapid destabilizing wave of mergers. It is clear that the States will act unevenly in different ways. My home State of Louisiana, for example, would fear invasion by Texas banks if we joined any great southern compact. We will move slowly. I think Mississippi might fear invasion of Louisiana banks and so on.

But if we keep it, for the short term, on this basis we will allow a broader based, more regionally spread out banking system to evolve. Also, I think we will have the immense advantage of avoiding a rapid destabilizing scramble for mergers.

Right now, for lots of complicated reasons and leadership personalities, the antitrust division is taking a very soft attitude in general toward merger activity. We've seen the results, particularly in the oil industry, which is very important to my region. There's a massive scramble for oil and gas assets and stock right now. If we should open the door abruptly and drastically to cross-boundary financial merger activity right now, in the face of international debt rescheduling, various insecurities, and with the worries and positioning for competitive advantage among major firms in the country, I think too much will go too fast.

I think it would be better to keep things going in a slower, gradual way. I think in retrospect, while we kept regulation Q around too long, in the long run, we properly killed it, and we now have a much healthier financial market system as a result.

I'd like to keep going with that pattern. Now we could have a very complex technical discussion on every other dimension here, including for example, deposit insurance and risk variability. That's a real can of worms and it's not so simple as many people suggest, because once you have a financial institution that's weak, if its risk premiums start going up, you start encouraging a run. So there's an inherent troublesome difficulty there that's not easy to regulate. Many other dimensions are the same.

Now on the whole, I have respected the gradual deregulation achievements. I know it's painful to have to sit through all these discussions. You must be bored to death having heard all of these arguments so many years, in and out, but I would urge, nonetheless, that patience does have a great benefit for the country as a whole. We can avoid serious mistakes.

The CHAIRMAN. No, you'd be surprised. Once in a while I hear something absolutely new that I have never heard before on any side of an argument.

You are primarily speaking in your response to me now about geographical deregulation and so on.

Mr. LOVETT. That I think is the greatest danger, breaking down those boundaries too fast.

The CHAIRMAN. In S. 2181, or S. 2134, or any of the bills before us—there are only provisions dealing with such things as the regional compacts. There is certainly nothing about McFadden in this bill other than that. There is no discussion at this time of going to interstate banking or breaking down those boundaries. We are primarily talking about powers and it seems to me we have to consider this in the logical sequence.

First of all, you can't decide who's going to be where or how they're going to be regulated until you decide who's doing what. In other words, powers, and authorities first. That's why there is nothing about regulation or the Bush Commission report in this bill either.

Would you agree that there has to be a logical sequence and that powers need to be determined first before you go to regulation or geographical distribution?

Mr. LOVETT. I think they're all carefully interrelated, and each of the industries is eager to make sure it has a regulation that it can live with and will fight very hard to maintain that sort of thing. I think the observations are correct that the regulatory format will probably follow powers and allocation of turf. But I would suggest, sir, that out in the marketplace there's a kind of trend or momentum, a fuzzier kind of thinking, if you will, which tends to say that there is a big trend toward erosion of all boundaries, and toward nationwide conglomerates in finance, and major action on powers of a drastic sort will accelerate substantially the geographic trend as well. We are getting into almost a hysteria mood.

The CHAIRMAN. Well, but if we do nothing, what happens in the marketplace? Doesn't exactly the same thing you're talking about happen, maybe even more psychologically difficult? Doesn't it create more of a bandwagon of having restrictions on part of the financial market while others, like Sears and the new people on the block have no geographical restrictions, no reserves, none of those things? Don't you develop a worse situation by not being willing to address the problems now?

Mr. LOVETT. I would address the extra risk factors that such enterprises might be getting involved into, but I really don't think the securities industry is causing that much of a threat lately. They have had a substantial reduction in their money market fund accounts. They are not competing as well in that area as the commercial banks and the more successful thrifts. And overall, I think the major nationwide commercial banks are much larger, more powerful organizations and we do have the special boon to them of generous deposit insurance. Personally, I think we might cut down the excessive size of that insurance per account. That would be one major change I would get involved in there, maybe $40,000 is plenty.

The CHAIRMAN. Concentrations are much heavier, if you take the 10 largest banking institutions, the 10 largest insurance companies, and the 10 largest securities firms. The concentration is much higher in the assets controlled by those 10 biggest securities firms or 10 biggest insurance companies than it is in the banking industry. So to me it goes beyond the issue of geographical and it goes beyond the issue of insurance. It goes to these companies that are getting involved in the banking business—Sears has Sears Savings Bank, Prudential owns Bache, American Express owns Shearson. Do we just sit back while all of those type of acquisitions go on and consider this gradually and carefully?

Mr. LOVETT. I would prefer that route. Also, I would say that the nationwide concentration is lower in banking because we've had the McFadden-Douglas boundaries. That has kept that industry much more geographically diversified and properly so.

The CHAIRMAN. Do any of the rest of you wish to respond on this general subject of the pace? I'm not talking about the substance of particular pieces of legislation, but on the need to address the problems and come to some decisions, or not to allow new powers for banks. Whatever the decisions may be, should we be making decisions in the near future or should we wait?

Mr. Horvitz. I don't think it's possible to slow down the pace of deregulation because with the exception of interest rate ceilings deregulation, we have made virtually no progress in recent years. To some extent we have increased restrictions. The recent legislation has put additional legislative barriers to bank holding company entry into the insurance business and while there has been progress on interstate banking at the State level, there's been no deregulation at the Federal level, and in fact the Comptroller's moratorium on nonbank banks is a step toward restricting what had existed under the previous law and regulation.

GOING BACKWARDS IN TERMS OF DEREGULATION

So I'd say we have been going not only slowly; we're probably going backwards in terms of deregulation at the Federal level in the area of geography and powers. So I would strongly disagree with Mr. Lovett's view that we ought to proceed slowly.

Clearly, the pace of deregulation should be much faster than it has been and I think this legislation is a substantial step in the right direction.

The Chairman. I think you're right. I think Mr. Lovett is getting his way. We have been proceeding very, very, very slowly for a long, long time. I've been trying to speed up that process. That's where we would disagree, I suppose. I appreciate your comments because deregulation turns out to be an inappropriate word to use for what we are doing because everybody then thinks of it in terms of transportation deregulation, airline and trucking deregulation, and the extent of deregulation that is perceived has taken place over the last 3 or 4 years is put into that kind of context.

Even if we enacted every deregulation proposal in the financial services industry that I've even heard about, that isn't even in the legislation, we would still have an incredibly regulated industry compared to trucking, transportation, or anything else. So when I hear all the safety and soundness arguments, it sounds like they think we're tearing down every single protective barrier for safety and soundness. The pace has been very, very slow and it has not kept pace with the marketplace. That's why you're getting so many aberrations and I hope, Mr. Lovett, you don't get your way. I hope we proceed more rapidly. It's all been on your side so far.

Mr. Eisenbeis. Mr. Chairman, I'd like to add that I would not only agree with you and disagree with Mr. Lovett, but I would also like to point out that it may be more destabilizing to avoid dealing with these regulatory issues than it would be to keep the lid on the pressure cooker. I think that maintaining binding regulations at a time when market pressures are accelerating only increase the vulnerability of the industry and also limit its ability to adapt to change. The classis example that we have is what happened to the thrift industry. Because thrifts were extremely regulated, we saw that when they were faced with high interest rates, they were not able to adapt.

The Chairman. That's true. During the years of all that regulation when the economy was stable it gave you guaranteed profit in the thrift industry. However, when the economy got out of control the regulations were the thing that put the thrift industry in such great difficulty.

Mr. KANE. With all due respect to Professor Lovett, the issue is the enforceability of the inherited exclusionary rules and portifolio requirements he values so highly. This is where contemporary lawmakers have to focus their attention. The changes taking place in the marketplace today show us that the cost of circumventing these rules and restrictions is falling steadily. Our inherited regulatory structure is effectively crumbing away. What good does it do to hold onto exclusionary rules, if by minor adaptation of organizational forms and in the names a firm calls its products, an institution may engage in prohibited activities? Geographic market exclusions in particular have become a laughing stock. For some time now, our Nation has had interstate banking. I don't care how many lawyers can convince themselves that we don't truly have interstate banking. All major institutions are now operating over multistate regions. One large bank has offices in about 49 States.

The CHAIRMAN. In the real world, it's already here and progressing regardless of what we do with McFadden. Are there any of you that support—let me preface that by saying there are a lot of people who agree that the marketplace is changing rapidly and we need to do something about it and their answer is a moratorium. Do any of you favor a moratorium?

Mr. KANE. We've had a moratorium for sometime now.

The CHAIRMAN. Partial at least.

Mr. KANE. I mean a moratorium on congressional action on the issues raised by nonbank banks and deposit-institution circumvention of exclusionary rules.

The CHAIRMAN. Right, but they're talking about a moratorium on a freeze, just everybody stand in place, Simon says stop, and stop the whole world while Congress carefully deliberates for several years.

Mr. BENSTON. I don't think that many economists would be in favor of that, particularly if you're forgetting one group, namely consumers. Mr. Lovett mentioned that he likes to bank at a particular bank. Well, I don't believe anybody can stop him from doing that. If it turns out many local people like local banks, then they will win the competitive game. If it turns out that they like the services at a Texas bank in New Orleans, then I presume they will bank with that bank.

The aggregate concentration ratio is totally misleading. It doesn't mean anything at all, if you talk about what percentage of assets are controlled by a bank. Nobody controls assets. Consumers effectively control the assets. They can shift them any time they wish.

The problem is that we, have constrained change for no reason at all except to protect people from competition by other producers and reduce the opportunities available to consumers.

The CHAIRMAN. Mr. Kaufman.

Mr. KAUFMAN. Senator Garn, I testified before your committee last June, I believe it was, and at that time I did favor a moratorium to give Congress a chance to act, and I believe some of the people here today were the same.

The CHAIRMAN. I remember that you did.

Mr. **Kaufman**. I think the 6 months are now over and I have given Congress the opportunity to act. I do not favor a moratorium any further.

Let me just make one other point about Mr. Lovett's comment. I did some research recently where I went back into the chain store controversy of the 1920's when there was a great fear that chain stores, especially in the grocery industry, were going to take over the country. They were going to be out-of-State chain stores coming into local communities, A&P, Safeway, et cetera, and there was tremendous opposition to such takeovers. There were proposed legislation at the State level and a lot of States did adopt legislation, and on the Federal level, the late Congressman Patman had a number of bills in the 1920's to limit chain stores. But those bills eventually failed and the consumers won. Those who wanted to shop at a local store, did; those who wanted services by national chains, did; and if we look at today's industry I think we find it very informative. We have a few nationwide chains. They are not necessarily the most profitable. Indeed, the largest chain a few years ago was on the verge of bankruptcy, the A&P. We have strong regional chains. We have local and day-and-night operations, the 7-11's. We have boutiques and "Ma and Pa" grocery stores, delicatessens. There's no fear of a national takeover and we have provided the consumer with the optimum choice. I don't think there's any debate today about should we reshape or regulate the grocery store industry.

The **Chairman**. Well, I think it's important that we try and maintain that diversity because I, like Mr. Lovett, prefer a bank in Utah. I've been here 9 years in Washington and I still have kept my bank account with the same bank, strictly a Utah bank, all of these years, and chosen not to select another one even though I live 2,300 miles away. I think that's the important thing in whatever we do, that we try to maintain that diversity and protect the dual banking system and give the consumers the opportunity to choose with whom they deal, and not be forced to choose by inappropriate Government regulation.

Mr. Lovett, you are so brave and so outnumbered today that I certainly want to recognize you again.

Mr. **Lovett**. I appreciate that, Senator. I would like to remind everyone what most of us probably appreciate, the process by which banking has become highly concentrated in most other countries of the world. In fact, there are only three highly decentralized banking systems. Ours is the most, Switzerland the next, and West Germany is fairly decentralized.

When Britain went through a centralization process at a much slower speed in the 19th century, they ended up with 40 banks right after World War I, and they had less than a dozen after World War II. They have six or so right now.

DANGER OF EXCESSIVE MERGER ACTIVITY

I'm terribly worried that there is a real danger of hysteria and excessive merger activity. That's why I don't see much risk or danger in slowing the pace of all this. If we calm things down, then the mergers will have to meet more of a market test.

My final parting shot would be—let's look at the 1970's and see how well the giant banks of Wall Street and the country managed their assets and loan portfolios. The result shows a very clear blunder, despite being able to hire the best of our Ivy League graduates, business school degree people, and so on. I mistrust bigness in finance and I hate like heck to see us throw away one of the great long-run guarantees of decentralized efficiency and political democracy in this country.

The CHAIRMAN. Do you also worry about not just concentration in the banking institutions but concentrations among any large financial institutions such as insurance companies, and securities firms? I'm concerned about inordinate concentrations regardless of what type of financial institution they are in.

Mr. LOVETT. That's right, and if we go too far in allowing banks to do anything, you will then lose the differentiating separation, and then you have the real problem of how to guarantee the deposits of part of their business, when they're free to use those assets to reinforce their other activities? There's a commingling of risks, and if we've learned one lesson in the long history of the supervision of banks, it's that this risk factor greatly increases when the bank owners are heavily involved in other conglomerate ventures.

The CHAIRMAN. I understand and I generally agree with that, but you just told me that you were worried about concentrations, as I am, regardless of where they came from. However, if you're unwilling to do anything as far as bank expansion, doesn't it necessarily follow that you would have to follow the philosophy that you just told me you agree with, that you would have to go the other route then and say we've got to prohibit Sears, American Express, and all these others from getting into the banking business?

Mr. LOVETT. I'd be willing to contemplate that and I would hope you would hold some hearings going down that road.

The CHAIRMAN. Well, I chose to go a different road, as you well know.

Mr. KANE. I wonder if I could defend the big banks? First, let me observe that they hire and promote some Ohio State University and other Big Ten graduates as well.

Second, I contend that their portfolio policies took them into such severe trouble, primarily because deposit-insurance subsidies led them to pursue what we can label today as excessive risks. However, only winning bets and investments look good after the fact. The proper way to evaluate bets and investments is prospectively. From an ex ante perspective, these soured investments looked pretty good. The risk taken in big banks loans to developing and Eastern bloc countries was subsidized in that the Federal Government and international institutions could be expected to take most of the down side. It was a case of heads the banks win, tails the insurance agencies, the U.S. Treasury, and the IMF lose.

These risks were subsidized not so much because of regulatory lags—as product-line and geographic market expansions have been—but because banks that made such loans were protected by political forces that made it hard for the FDIC to sanction these loans. It is not hard to imagine the political furor that would have been directed toward any FDIC official who dared, without hard evidence of threatened default, to label loans to a particular subset of friendly or semifriendly countries as substandard. It was politically impracticable for FDIC examiners to criticize these loans energetically enough to rein in this kind of risk-taking.

Moreover, the banking system hasn't actually lost much money in these loans. It looks to me as if banks' judgment that the political system would save them from the risks in these loans is being borne out.

The Chairman. Well, I agree with Mr. Lovett that they made some bad mistakes and blunders, but if you're going to look at the big banks in the 1970's, you've also got to look at some of their activities and expansion and how miserably they failed in the domestic markets as well. Walter Wriston sat right there in your seat and when I asked him how well he did in upstate New York, Citibank, he said, "They cut off my head, put it on a silver platter, and sent me back to New York City," because they did so notably poorly in competition with the small local banks. In 1982 I'm sure you're aware there were more new banks formed in California than in any year in the history of California with Bank America right there. There was a great retraction among the big banks in closing down branches, obviously partly due to ATM's and electronic funds transfer. Nevertheless, there were a lot of unprofitable branches of the big banks that were not competing with the local bank at all, which would support what you're saying, Mr. Kaufman, about the small grocery store, but I really don't foresee that you're going to have this type of concentration that everybody fears. I really don't think you're going to see 14,000 banks, even if you had immediate removal of McFadden, I think a lot of people would be surprised at how well our banking system would do and how much of a mistake many of our large banking institutions would make if they thought they were able to compete on a broad base across the country. I don't think they would be able to.

Mr. Eisenbeis. Mr. Chairman, I'd like to agree with your observations about the underlying fundamental economics that would or would not drive a consolidation. I would be much more concerned about the potential for increased concentration of resources if we looked at the balance sheets and saw higher returns on assets, higher rates of return on equity for large institutions than for small institutions. That would provide some evidence that there were some efficiencies and economies of scale in size, but as Professor Benston can well attest, the empirical evidence doesn't support the production and efficiency advantage of a large organization. Under those circumstances I don't see the underlying economic forces generating a consolidation movement that would lead to concentration of banks in this country.

I think there will always be room for profitable and efficiently run institutions.

Mr. Benston. I'd just like to add something very briefly. I live in upstate New York and Citibank's attempt to get up there was very beneficial to us, the consumers, because they sharpened up our local banks. These banks did react very well to the move upstate by the New York City banks. Citibank was quite right. They didn't do well, but our banking is better because they attempted—from the consumer's point of view it's desirable.

Also, if you live in an area that happens to be near State boundaries, then it is desirable if banks can cross the line. A natural market area can include more than one State. But this is not allowed because of branching restrictions. Consequently, consumers are harmed.

And finally, if banks want to establish private check collection systems to compete with the Federal Reserve, they can't do this because picking up checks in another State is considered interstate banking. That's a major restraint on the development of a more efficient payment system.

So the concentration argument is, if anything, the opposite of that Mr. Lovett expressed and it has other ramifications as well.

The CHAIRMAN. Gentlemen, thank you very much. We appreciate your testimony and the willingness of each of you to appear today.

[Response to written questions of Senator Garn follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN

FROM

ROBERT A. EISENBEIS, PROFESSOR, SCHOOL OF BUSINESS ADMINISTRATION,

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School of Business Administration
Carroll Hall
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May 23, 1984

Senator Jake Garn
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Garn:

This is in response to your request for my response to a question that came up subsequent to my testimony before your committee on March 13, 1984 on S.2181 and S.2134, financial institutions deregulation legislation.

Question:

Your statement opposes segregating different financial activitities in separate bank holding company affiliates, but you do not discuss the advantages of regulation by function. Might it not be useful to put bank securities activities in a separate subsidiary so it could be regulated by the SEC.

Answer:

There are two important reasons why segregating securities activities into separate subsidiaries so as to facilitate SEC regulation is unnecessary.

First, it is important to distinguish between regulation and enforcement of securities activities. Securities regulation involves the promulgation of rules and regulations governing firms'activities as they concern the issuance and sale of securities to the public. This activity can be performed efficiently on a functional basis in most instances. It does not follow, however, that the agency which promulgates and interprets regulations must also enforce those regulations. To force an organizational structure on depository institution, which may impose costs and possible inefficiencies, in order to facilitate enforcement of regulations seems to me to be unnecessary and unjustified. I can't rationalize imposing costs on depository institutions to make the life of the regulators easier. There is no reason why the banking agencies, for example,as part of their compliance examinations, could not check for compliance with securities regulations, as they do now. This separation of regulation and enforcement may be a very efficient way to implement securities laws.

Second, it has been long argued by the banking agencies that certain kinds of securities regulation, such as disclosure rules, may conflict with safety and soundness objectives, and in particular, the protection of depositors. Therefore, to minimize these perceived conflicts, functional regulation should not be followed. At issue is the question of when there may exist inherent conflicts between regulatory objectives, is it better to externalize the resolution of those conflicts or is it better to leave their resolution to one particular agency by consolidation of regulatory responsibility? The answer lie in the nature of the conflicts and how one wants them resolved.

Professor Manferd Peterson of the School of Business at the University of Nebraska, has written an enlightening paper on these issues entitled "Bank Regulatory Objectives and Conflicts," forthcoming in a book edited by Richard C. Aspinwall and Robert A. Eisenbeis (John Wiley and Sons: New York, New York, 1984). He clarifies the issues and points out that conflicts can exist either between regulatory goals or in the way they are implemented. The key for public policy is to determine whether the conflicts are inherent, because of conflicting goals or whether the conflicts exist, because of the way they are enforced. His analysis suggests that most conflicts are in implementation. Thus, functional regulation(but not necessarily enforcement) would be appropriate so as to resolve any conflicts in the public arena.

The case of disclosure is a particularly interesting example, and provides a strong argument for functional regulation. Prior to the growth in importance of Bank Holding Companies, the banking agencies regulated disclosure of banking organizations. Whenever a conflict arose between the interests of shareholders and depositors, the banking agencies always tended to resolve the issue in favor of depositors because of the relatively greater weight they gave to avoiding runs on banks as compared with protecting the interests of owners. For example, the agencies did not make public either the Reports Of Condition or the Reports of Income for fear that release unfavorable information would trigger a bank run. With the growth of Bank Holding Companies, however, which were subject to SEC and not banking agency disclosure requirements or enforcement authority, greater disclosure was forced on the banks through their parent holding companies in response to SEC pressure. The result was an increase in information being made to the market when the SEC was in control of disclosure policies. Moreover, we have since discovered that disclosure can actually aid banking supervision by increasing the discipline of the market. Thus, what was perceived to be in conflict banking supervisory policies was shown to be complimentary. The dispute over disclosure policies was externalized and resolved differently, when the SEC gained functional jurisdiction for rule making and interpretation of the statutes through the bank holding company form of banking organizations. Such functional regulation led to a different, and in this case, better public policy than institutional regulation.

In summary, I see no reason to justify the separate affiliates approach in order to facilitate SEC regulation and enforcement of the Securities Acts. These two activities as separate and distinct. On the other hand, these is no evidence to suggest that enforcement of laws and related regulations need to be done by the agency promulgating those regulation.

Sincerely,

Robert A. Eisenbeis

Robert A. Eisenbeis
Wachovia Professor of Banking

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN

FROM

PAUL M. HORVITZ, PROFESSOR, DEPARTMENT OF
FINANCE, UNIVERSITY OF HOUSTON, HOUSTON, TX.

Question for Professor Horvitz

Your statement supports the proposal in S.2181 to allow bank holding companies to make limited equity investments in affiliates engaged in real estate development.

This was opposed in testimony last week before the Committee by the representative of the National Association of Home Builders.

He argued that banks' competitors in the real estate development business would be at a competitive disadvantage because: (1) banks could extend financing at favorable rates to their own real estate development affiliates and (2) banks could deny mortgages to homebuyers unless they purchased homes in projects developed by the banks' affiliates.

How would you respond to these NAHB concerns?

Answer:

The argument of the National Association of Home Builders is identical with the "tie-in" argument raised in connection with every proposal to liberalize the powers of bank holding companies. There are two counter-arguments to this, a legal argument and an economic one. The legal one is simple--such tie-ins are illegal, and if the law needs strengthening, it can be strengthened. But I view the economic argument as more convincing. A bank can exercise such power only if it has monopoly power in the basic service (credit, in this case). Since I do not believe that any bank has such monopoly power in mortgage lending, it will be unable to force a mortgage loan applicant to buy a house in one of the bank's projects. And if the bank had such monopoly power, it would use it, presumably by charging higher mortgage rates, even without the authority to engage in real estate development. That is, consumers would not be protected from this monopoly power by restrictions on bank real estate activities. The consumer's best protection, in this as in other areas, is a vigorous, competitive system.

It may be reasonable for the Home Builders to oppose allowing banks to take an equity position in real estate financing, since under the present restrictions a bank is limited in its negotiations on terms with builders. Some real estate lending by banks subjects them to all the risks if the project is unsuccessful, but limits them to a fixed return if all goes well. But the basis of the proposed legislation is not what is best for banks or for builders, but what is in the public interest. Allowing banks to take an equity position will stimulate banks to participate in a type of financing they may have avoided for the reason just mentioned. Broader bank participation in financing development will increase competition and benefit consumers.

Question for Professor Horvitz

Fed Already Has Power to Allow Insurance, Securities, etc.

In your written statement, you assert that the Federal Reserve already has the power to grant bank holding companies insurance and securities powers, but has withheld such powers out of a failure to correctly grasp Congress's intent contained in the Bank Holding Company Act. You cite the Fed's refusal to permit banks to engage in financial consulting as a "ludicrous" example. Could you elaborate on this statement?

Answer:

When Congress was considering amendments to the Bank Holding Company Act in 1970, there was a great deal of discussion as to which financial activities bank holding companies should be allowed to engage in (there was general agreement that bank holding companies should not be allowed to engage in non-financial activities). The solution embodied in the 1970 Amendments was to delegate to the Federal Reserve the authority to determine the "laundry list" of allowable activities based on changing economic conditions, rther than having Congress specify a list in the legislation. It was expected by virtually all observers that the Federal Reserve would allow bank holding companies to participate in a broader range of financial activities than was open to commercial banks. In fact, the Federal Reserve has taken an extremely restrictive approach to its mandate. There are no more than one or two activities on the list of those allowable under Section 4(c)(8) of the Act that are not legal for national banks directly, without the need for the bank holding company route. The extreme example I noted in my testimony was the denial of an applicaiton for a bank holding company to engage in financial consulting, despite the fact that financial consulting has traditionally been a major activity of commercial banks (though perhaps under different nams). The specific case I had in mind was the proposed acquisition of Golembe Associates, Inc. by Marine Midland, though there may well have been others. In any case, it should be noted that even the Federal Reserve eventually recognized the weakness of its logic, and has since allowed some similar applications.

April 17, 1984

Answers to Questions Submitted by Senator Garn Subsequent to the Committee's March 13, 1984 Hearings

EDWARD J. KANE, PROFESSOR, DEPARTMENT OF ECONOMICS,
OHIO STATE UNIVERSITY, COLUMBUS, OHIO

a. What is the size of the deposit-insurance subsidy?

The aggregate deposit-insurance subsidy is enormous, but it is hidden away from plain view. It is like a vast underground system of tunnels that no one sees until he looks for it.

The underground portion of this subsidy is the value of unfunded FDIC and FSLIC guarantees. This value represents a substitution of government for private equity capital that should be plainly recorded on the balance sheets of insured and insurers alike. Because neither insured institutions nor agencies do book this value, it has grown far bigger than is generally recognized and has slipped administratively out of control. Using accounting data, I estimate (using a procedure that is explained in an article published in the July, 1982 issue of the Housing Finance Review) that in December 1982 unrealized losses on the mortgage portfolios of insured S&Ls and mutual savings banks exceeded the book value of their combined net worth by an amount between 100 billion and 175 billion dollars. Using a stochastic-process model, my colleague J. Huston McCulloch has shown analytically that the value of deposit insurance to an insured institution varies directly with: (1) the level of interest volatility in the marketplace; (2) the mismatch between the duration of the institution's assets and liabilities; and (3) the institution's capital-to-asset ratio. Using his estimate of the level of interest volatility obtaining in December 1982, McCulloch calculates the value of federal insurance guarantees as a function of the size of an institution's asset-liability mismatch and leverage. For an institution whose capital-to-asset ratio was as low as one percent and whose asset-liability mismatch was one year, the guarantee would be worth 2.10 percent of its liabilities per year. If these figures for leverage and asset-liability mismatching were representative of the thrift industry as a whole, aggregate guarantees would be worth $15 billion per year. Discounting this value at 10 percent takes capitalized value of insurance guarantees back to the neighborhood of $150 billion. Because today the subscribed net worth of few thrift institutions is positive in market value, even if the asset-liability mismatch were only six months, the value of the guarantees would remain substantial.

Troubled loans further increase the value of unfunded deposit-insurance guarantees. Large unbooked losses on loans to underdeveloped countries and energy-related firms are currently supported by FDIC guarantees. I could easily estimate the subsidy in troubled loans if the FDIC and FSLIC would only require its clients to report the market rather than book value of their various assets. If government officials wanted to know the value of unfunded FDIC and FSLIC guarantees, they could establish baseline market values by arranging to auction a selection of the billions of dollars in liquidation assets now owned by the FDIC.

An alternative way to approach the size of the deposit-insurance subsidy is to compare the insurance premium with risk premiums earned on different investments or paid on an insured institution's uninsured liabilities. Federal law currently sets the explicit premium for this insurance at 8-1/3 basis points per year and even mandates that a some of this premium be rebated to FDIC clients each year based on FDIC loss experience. In 1981 and 1982, the spread between yields on uninsured large-denomination certificates of deposits and those on Treasury securities averaged more than 100 basis points. Although this spread has since narrowed for most banks, those with substantial amounts of troubled loans still find it necessary to pay substantial premiums. On the asset side, it is enough to note that, in January and February 1984, the spread between Aaa and Baa corporate bonds was 145 basis points. Since a federal guarantee permits risky assets to be financed at riskless interest rates, the subsidy to prudent investments in Baa-quality assets exceeds 135 basis points.

b. What Changes Should be made in the deposit-insurance system to remove the subsidy?

The purpose of deposit-insurance reregulation may be framed as making the FDIC and FSLIC act more like private insurers, so that they better protect their and taxpayers' economic interests and make uninsured depositors and stockholders bear more of the risk inherent in deposit-institution operations. Successful reregulation must administratively expand opportunities for troubled individual institutions to experience runs and even to fail. However, these changes not only need not increase the threat of system-wide instability, by improving risk-taking incentives they should decrease this threat.

I am enclosing an article from the July, 1983 Housing Finance Review that goes into this question at length. However, I can summarize five recommendations for you here. These recommendations do not stand or fall together. Adopting any subset of these reforms will reduce the subsidy to risk-taking inherent in the current system.

1) Full disclosure of adverse information: Since 1938, regulators and accountants have allowed deposit institutions to make use of so-called "intrinsic-value accounting." Re-instituting market-value accounting for deposit-institution loans and investments can be justified as a cost-effective scheme for raising the implicit premium on deposit insurance in a risk-sensitive way. The most attractive aspect of this approach is that it would let market forces rather than bureaucrats conduct risk assessments and set risk premiums. In a world where declines in market value are not papered over by book-value accounting, deposit-institution managers who are tempted to pursue unregulated risks would know that they face quicker and more extensive damage to their careers when and if these risks go awry.

If they are to bear more of the risk of failure, investors in deposit institutions and coinsuring depositors (those that are less than fully insured) deserve best-efforts estimates of the risk exposure and changing market value of the assets and liabilities that deposit institutions book. To produce such estimates, one need employ concepts no more sophisticated than present-value calculations. Hand-held calculators now permit any literate person to carry out present-value calculations. Market discount rates to input into these pre-programmed computations can be collected from secondary markets, supplemented where necessary by insurer-arranged auctions of similar assets, called precisely to generate market estimates of the value of questionable assets.

Until very recently, neither government nor industry has wanted to establish such base-line values. One may interpret mandated disclosure of bank positions in troubled foreign loans and of S&L interest-sensitivity gaps required in 1984 as administrative steps in this direction.

2) Expanded opportunities for deposit-insurance agencies to manage their risk exposure: To neutralize political pressure for forbearance, deposit-insurance agencies need enhanced rights to take timely action to cancel insurance coverage or to foreclose on the bank's charter before an institution's net worth is exhausted. The major point is to stop institutions that are insolvent *de facto* from being permitted to make spectacularly risky endgame plays with FDIC and FSLIC (i.e., taxpayers') money.

In recent years, failing institutions have made spectacular plays with brokered funds. Strengthening insurer rights could occur in many ways:

a) Most important is the development of a new technique for resolving failures know as the "indirect or modified payoff." In one variant of these transacitons, the FSLIC sells only a failing firm's *insured* deposits to an acquiring institution and offers to lease the dead institution's premises to the acquirer. The FDIC approach is to sell off only a bank's insured deposits plus the FDIC's estimate of the recoverable percentage of uninsured deposits. If not overruled by the courts, these techniques can make uninsured creditors take their lumps in liquidation without greatly disrupting the financial lives of a failed institution's insured customers.

b) Another step is to limit the pyramiding of an individual's insured accounts. The current proposal to limit insurance of brokered funds is best seen as a significant move in this direction. Complementary proposals under FDIC consideration include deleting insurance coverage for deposits held by any financial institution and eliminating coverage for various forms of trusteed accounts. Trusteeships represent an obvious avenue for circumventing the agencies' new limitations on brokered accounts.

c) A useful third approach would be to impose cumulative limits on an individual or institutional depositor's lifetime claim against federal deposit-insurance agencies. Such a limit would parallel coverage patterns in major medical insurance. The purpose of this limit is to make even insured depositors "care" whether brokered funds go to underwater institutions.

d) Finally, a less controversial approach would be to develop an information base on the interest-rate gaps and other risks assumed by FDIC and FSLIC clients. Using this information, agency asset-liability committees could be set up to buy offsetting options on futures contracts.

3) Recalibration of insurance coverages: Risk arbitrage can occur because deposit insurers have less information about an institution's risk exposure than deposit-institution managers have. To reduce the asymmetry, the pattern of coverages must be altered to generate information on clients' own perceptions of the benefits from insuring different kinds of risk and of their willingness to pay for alternative forms of coverage. As a strategy for assembling information with which to improve the rating process, I would recommend three changes in contract provisions:

   a) Lowering the basic coverage per account (say to $10,000), with future limits indexed for inflation to make it less easy to reintroduce the real value of this coverage into the political arena. The decision to increase FDIC and FSLIC account coverage to $100,000 was a serious mistake.

   b) Differentially pricing successive layers of optional supplementary coverages (offered, say, in $10,000 slices) and adjusting these prices in accordance wth market principles.

   c) Introducing provisions for deductible and coinsurance elements into this supplementary coverage. These elements could include progressive declines in proportionate coverage or provisions imposing additional penalties on stockholders of a failed deposit institution, as was the practice in the days before Federal Deposit Insurance existed.

4) Risk-rated explicit premiums: These are needed to relegate implicit premiums on recognized forms of risk-taking to a lesser role. The many opponents of this change emphasize that setting explicit premiums is a difficult task, requiring a considerably larger base of information than is collected today. Difficult as it may be, the task is not impossible. Private insurance companies contemporarily price many exotic forms of risk including the dangers of computer crime, divorce, cancer, tax audits, and space debris (the amount of which has been both increased and decreased by recent missions of the space shuttle). What is impossible is permanently maintaining a system that insures risk borne by deposit institutions at a price that lies far below the return offered in capital markets for risk-bearing services.

   Because risk-sensitive pricing is a hard task and requires considerable adaptive efficiency, it seems dangerous to assign the function wholly to government officials. This leads to the fifth point in my program.

5) Meaningful opportunities for private competititon in deposit insurance: To introduce competitive discipline, it is necesssary to provide opportunities for private firms to issue or reinsure at least some layers of supplementary deposit-insurance coverage. To neutralize political pressure for low prices and uneconomic coverages, authorities must invite into the contract-design and contract-pricing process decisionmakers whose only stakes are economic -- parties whose jobs and firms can and will be wiped out if they issue contracts which fail to make it each client's own best interest to keep its risk exposure within prudent bounds.

c. Do brokered deposits increase pressure on the insurance system and provide "protection" for nondepository corporations?

Indeed they do. Customers have always had the option of circumventing limits on accountholder coverage by opening up separate accounts in a series of deposit institutions. However, when a customer does this without a broker's help, he incurs substantial shopping and other transactions costs that limit the extent to which setting up multiple relationships is profitable behavior. Multiplying one's insurance coverage in this way generates expenses that make the extraction of deposit-insurance subsidies about as efficient as pounding dust out of a carpet with a rugbeater. If transactional inefficiencies could be eliminated, arbitrageurs could draw unintended subsidies for the deposit-insurance system with the ease of a well-functioning vacuum cleaner. Officials are right to worry that CD brokers make it possible for sharp customers and deposit-institution managers to extract unintended subsidies out of our nation's actuarially unsound deposit-insurance system with unprecedented ease and in potentially unsustainable amounts.

Spokespersons for the deposit-brokerage industry claim that proposed FDIC and FSLIC coverage limits would put their industry out of business. This is economic nonsense. The FDIC and FSLIC proposal does not proscribe deposit brokerage. It merely walls off brokers' access to the deposit-insurance subsidy. Currently, this subsidy is being shifted into CD brokers' fees. We must ask ourselves whether letting themselves be knocked out of the game is the best way that CD brokers can respond to the proposed rule. Spokespersons for the brokerage industry insult our and their managers' intelligence in proclaiming that it is. Clearly, brokerage firms have the option of self-insuring their customers or purchasing supplementary deposit insurance from private sources. The resulting insurance costs would have to be divided between brokers and the buyers and sellers of brokered CDs. But it is not inherently more unfair to let the direct users of these services bear the insurance costs than it is to impose them on the general taxpayer.

Of course, authorities could control deposit-insurance subsidies available to brokered CDs in ways that would not place so large an adjustment burden on the CD-brokerage industry or on its particular customers. The best policy would be for the FDIC and FSLIC to adopt risk-rated insurance premiums, a move which would have the further advantage of curtailing much of the other turmoil currently besetting the contemporary financial-services industry.

For your information, I am enclosing a fuller statement on this issue that I presented before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations on March 14, 1984.

A Six-Point Program for Deposit-Insurance Reform

by Edward J. Kane*

To offset the subsidy to risk-bearing that a deposit-based structure of explicit premiums creates, deposit-insurance agencies levy regulatory penalties (*implicit* premiums) on clients that are perceived as imposing unacceptable risks on the insurance agency. The weakness of this system is that bureaucracies are ill-adapted to playing catch-up ball. Lags in recognizing emerging categories of voluntary risk-taking and deteriorations in client net worth let aggressive institutions reap rewards from discovering innovative ways to bear risk and from pursuing these opportunities until the insurance agencies identify them and regulate the advantage away.

Ironically, though sizeable in magnitude, deposit-insurance subsidies have not greatly enriched the deposit-institution industry. Competition by insured institutions for subsidized borrowing and lending opportunities is so intense that deposit-insurance subsidies are almost completely shifted to borrowers and funds suppliers. But subsidizing risk-taking does increase the fragility of the U.S. financial system.

To succeed in curtailing the amount of risk that insured institutions pursue, it is necessary to design deposit-insurance contracts that at the margin make risk-reduction in a client's own best interest. This requires disclosing timely and market-based information on an institution's earnings performance and sharply reducing the level of automatic insurance coverage per account. To neutralize political pressure, it also requires inviting into the contract-design and the contract-pricing process decisionmakers whose jobs and firms can and will be wiped out by

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mis-shaping and mispricing. The FDIC and FSLIC need to contract out at least some of their insurance risk to private companies, while Congress needs to legislate that, if a private insurance firm can't meet its guarantees, it will be summarily liquidated. At the same time, unpriced de facto back-up guarantees of these firms' liabilities by government agencies should be statutorily restricted to actual (rather than merely suspected) waves of failures. Unless the opportunity to effect short-sighted politically motivated rescues of individual institutions is carefully circumscribed, even private competition cannot prevent deposit-insurance risk from remaining seriously underpriced.

I. Introduction

Defenders of the status quo in federal deposit insurance remind me of two government building inspectors who accidentally tumbled off the roof of a 60-story building. As they fell past the windows of each of the top 50 floors, they loudly reassured each other and the building's occupants, "So far, so good." My point is that, whatever good the deposit-insurance system has accomplished in the past, its momentum is propelling it in the direction of a bureaucratic disaster. Unless market discipline is reimposed on deposit-institution risk-taking, the deposit-insurance bureaucracy is eventually going to go *SPLAT*.

I want to emphasize that I am not predicting a crisis for deposit-institution customers. Although such an event is not totally out of the question, the politics of central banking and deposit-institution regulation make it unlikely. Subsidized emergency loans to threatened institutions provide a politically quick and easy way to arrest a systemic run on deposit institutions were one to get under way. But repeated doses of bailout medicines run the risk of cumulating into a de facto nationalization of the deposit-institution industry.

II. What's Wrong with the Inherited System? Why Isn't it Politically and Economically Sustainable?

Currently, federal deposit insurance fully guarantees an institution's deposit accounts up to $100,000 per accountholder, with accounts held singly and jointly being afforded a separate insurance status. These guarantees are supported by *explicit* premiums of $1/12$ of one percent of total (insured and uninsured) deposits booked at domestic offices. Because this pattern of explicit pricing is not sensitive to differences in either interest-rate volatility or a client's leverage and asset risk, client risk-taking must be regulated directly. We can view capital-adequacy requirements and back-up regulatory penalties for excessive risk-taking as implicit premiums that agency managers vary to control these and other bureaucratically *recognized* forms of risk-taking.

Three things are wrong with this coverage and pricing system. First, it is allocationally inefficient (an economist's mortal sin). By mispricing risk, it wastes scarce resources. Second, it is distributionally unfair (a political scientist's mortal sin). It forces conservatively managed deposit institutions to underwrite highflying competitors. Third, it fosters financial instability (a societal nightmare). It subsidizes deposit-institution risk-taking most when markets are most volatile and loads the burden for financing this subsidy onto both conservatively managed deposit institutions and taxpayers at large. Because this premium structure subsidizes *unregulated* forms of risk-bearing, it leads to a continual search for (and expansion of) new forms of risk-taking. It also leads bureaucratic conceptions of operative categories of deposit-institution risk-taking to play the pivotal role in making the system work.

Federal deposit insurers need not suffer losses if they are quick to adapt their regulatory policies to emerging problems. But bureaucrats are inherently slower in responding to changes in interest-rate volatility and other emerging forms of risk than private insurers would be. Politically appointed agency heads typically have short horizons and are sensitive to political constraints that overlay an agency's strictly economic interests in the decisions it makes. This leaves government bureaucracies notably low in *adaptive efficiency*. This relative weakness makes it unwise, in a financial-services environment that is changing as rapidly as our own, for an agency to follow policies that thrust its adaptive efficiency in protecting its economic interests into a key role. Such an agency ends up operating out of its element, much like a fullback-oriented football team that is forced to play catch-up ball in a big game. (I apologize if this analogy seems more vivid to a professor from Ohio State University than it does to the typical reader).

For reasons that seem illogical to me, generally accepted accounting principles do not require that the value of unfunded guarantees be placed on insureds' and insurers' balance sheets. Because neither clients nor agencies book this value, it has grown far bigger than is generally recognized and has slipped administratively out of control. I estimate [Kane, 1983] that, in December 1981, unrealized losses on the mortgage portfolios of insured S&Ls and mutual savings banks exceeded the book value of their combined net worth by between 100 billion and 175 billion dollars. McCulloch [1983] shows analytically that the value of deposit insurance to an insured institution varies directly with: (1) interest volatility, (2) the mismatch between the duration of the institution's assets and liabilities, and (3) the institution's asset-to-capital ratio. Using his estimate of the level of interest volatility obtaining in December 1982, McCulloch calculates the value of federal insurance guarantees as a function of the size of an institution's asset-liability mismatch and leverage. For an institution whose asset-to-capital ratio was as low as 100 and whose asset-liability mismatch was one year, the guarantee would be worth 2.10 percent of its liabilities *per year*. If these figures for leverage and asset-liability mismatching were representative of the thrift industry as a whole, aggregate guarantees would be worth $15 billion per year. Discounting this value at 10 percent takes capitalized value of insurance guarantees back to the neighborhood of $150 billion. Because few thrift institutions have positive net worth, even if the asset-liability mismatch were only six months, the value of the guarantees would remain substantial.

A policy of routinely bailing out all but each agency's most devastated clients has induced a massive and ongoing *substitution* of equity in the form of deposit-insurance guarantees for private equity in deposit institutions. Through these guarantees, the federal government has become the leading supplier of equity funds to deposit institutions. The nation appears to be trodding a back-door path to the de facto nationalization of the deposit-institution industry, an unintended nationalization that is symbolized by government operation of phoenix combinations of failed S&Ls. To reverse the momentum, incentives to invest private capital in deposit institutions must be restored.

III. Updating Regulatory Conceptions of Operative Deposit-Institution Risk

For deposit institutions, failure is best defined as a regulator-induced cessation of independent operations. Deposit institutions fail because risk-taking lies at the heart of their business. The more risk (net of diversification) that a deposit institution takes on, the higher its return but also the greater its chance of failure. A problem institution's potential or actual insolvency contributes to its failure, but the decision to close out its existence rests with supervisory authorities who have chosen to focus on book values rather than on market values per se.

To show how rapidly the relevant risks of deposit-institution operation are changing, Table 1 attempts a taxonomy of banking risk. The basic distinction is between the risks a bank incurs as an institutional investor and those it incurs as a producer of financial services. Of the nine forms of risk distinguished in the table, four have dramatically increased in importance during the last four years: interest-volatility risk, subsidiary risk, regulatory risk, and technological risk. During the same interval, making loans to governments and government-sponsored firms in less-developed and Eastern European countries exploited a category of credit risk that (presumably for political reasons) was too long left unregulated. Growth in these risks was stimulated by regulatory lags inherent in controlling deposit-insurance subsidies to unregulated forms of risk.

IV. Insurance Subsidies are Shifted

Ironically, although deposit-insurance subsidies provide short-run benefits for aggressive institutions, they do not permanently enrich the deposit-institution industry. Competition by insured institutions for subsidized borrowing and lending opportunities is so intense that deposit-insurance subsidies are ultimately shifted through to borrowers and suppliers of institutional funds. In competitive markets, subsidies are inevitably captured by owners of the scarce resources engaged in that enterprise. In the 1970s, profits made by institutions that first exploited such unregulated risks as maturity mismatching and sovereign lending were bid down by

TABLE 1
COMPONENTS OF PORTFOLIO RISK FOR A DEPOSIT INSTITUTION

Financial Risk

Risk of breakdowns in the firm's system for encouraging internal integrity	Risk of losses passed along from affiliated (including subsidiary) institutions	Liquidity Risk: the risk that servicing an unpredictable surge in net clearings and cash withdrawals will impose substantial expenses on the firm	Credit Risk: the risk that borrowers will default on promised repayments	Interest-Volatility Risk: the risk that changes in the level of market interest rate will affect the market value of assets and liabilities differently	Foreign-Exchange Risk: the risk of unfavorable fluctuations in the value of assets and liabilities denominated in foreign currencies

Service-Facilty Risk

Risk that the firm will operate at less than maximum efficiency	Risk that unforeseen regulatory action will impair the form's profitability	Risk that changes in technological opportunities will reduce the value of the firm's existing systems for producing and delivering financial services

competition from follower institutions that were eager to participate in attractive opportunities. Ultimately, this competition transferred the subsidy to mortgage and foreign-country borrowers. In 1983, competition for insured money-market accounts is in the process of transferring some of the insurance subsidy on maturity mismatching to depositors. This explains how the sum of implicit and explicit returns on these accounts could remain persistently above yields on short-term Treasury securities and even on money-market funds.

More generally, deposit-insurance pricing subsidizes the interest-volatility risk that S&Ls take in making fixed-rate mortgage loans. Subsidization occurs because explicit deposit-insurance premiums are based on total deposits, and Congress strongly approves of maturity intermediation when it is undertaken by S&Ls to support mortgage lending to households. Political pressure prevents the FSLIC from administratively imposing a fully countervailing implicit premium on S&Ls that borrow short to hold long-term fixed-rate mortgages. This leaves the price of risk-bearing earned in fixed-rate mortgage lending far above the price charged for laying this risk off on the FSLIC.

Basic price theory tells us that competition should shift much of this subsidy forward to mortgage borrowers and backward to holders of insured money-market accounts. Given that insured institutions face a positively sloped yield curve, this process can account for the persistently low value of two important yield spreads. First, it can explain why insured money-market accounts at many institutions offer better total returns (i.e., implicit plus explicit interest) than Treasury securities of comparable maturity. Second, it predicts that interest rates on fixed-rate mortgages held for an insured institution's own account would be forced artificially lower than the free-market equilibrium yield on these instruments.

Current activity in residential mortgage markets underscores the perverse effects of the FSLIC's continuing to subsidize interest-volatility risk. The financial press reports that S&Ls are jumping back into fixed-rate mortgages with the fervor of a previously reformed alcoholic returning to booze. Preliminary FHLBB figures (published in the July 1, 1983, *The Wall Street Journal*) show that, between December 1982 and May 1983, almost 70 percent of conventional mortgages originated by S&Ls carried fixed rates.

Although we have no data yet on the percentage of these mortgages that are merely being packaged for resale in the secondary market, observers fear that a large proportion of these loans is being retained in S&L portfolios. This fear is reinforced by the low spreads that exist between rates on fixed- and adjustable-mortgage instruments and between yields on insured money-market accounts and Treasury securities of comparable maturity. These spreads suggest that S&Ls seeking to arbitrage the price of risk-bearing services are among the marginal lenders in the market for fixed-rate mortgages.

The interest-volatility risk in fixed-rate mortgages held in an institution's own portfolio is currently subsidized by the FSLIC, whereas adjustable-rate mortgages shift that risk to the borrower and (if only because of the risk of negative amortization) impose a greater risk of default besides. To most borrowers, having to absorb a risk that (at the margin) fixed-rate contracts leave largely unpriced, makes interest rates on adjustable mortgages seem too high. At the same time, S&Ls' unique opportunity to arbitrage the price of risk-bearing between deposit, mortgage, and insurance markets makes them resistant, in practice, to opportunities for asset diversification that, in theory, their trade associations strongly favor. To an individual S&L, diversifying away a risk that the FSLIC is unable to protect itself against reduces the aggregate value of the subsidy this S&L could otherwise extract for its customers from the FSLIC.

Both consumers and consumerists recognize that the differential yield between fixed-rate mortgages (FRMs) and adjustable-rate mortgages (ARMs) seems too low to price the favorable prepayment and rollover options that an FRM confers on the borrower. They suspect lenders of unfairly using monopoly power to keep the ARM rate above its market value. But the role of the deposit-insurance subsidy suggests the FRM rate may be the artificial rate. The yield differential may be too small because the FRM rate is too low, not because the ARM rate is too high.

V. A Six-Point Program for Reregulation

The deposit-insurance subsidy to risk-taking has greatly increased the fragility of our financial system. To cut back voluntary risk-taking, it is necessary not only to *reprice* but also to *redesign* the existing system of deposit-insurance coverage. The FDIC and FSLIC must develop incentive-compatible insurance contracts and price them fairly. In a world in which deposit institutions are highly levered and interest rates are highly volatile, systematically mispricing deposit-insurance guarantees encourage deposit-institution managers to position their firms on the edge of financial disaster. Metaphorically, deposit-insurance authorities are paying deposit-institution managers to disco on the window ledges of financial skyscrapers all over the country. The task of reregulation is to coax the dancers back inside each building's walls before it becomes too late.

Currently, low-risk deposit institutions pay unreasonably high premiums for deposit insurance, while high-risk institutions receive insurance at what is a bargain rate. Contractual incentives must be established that would allow a low-risk institution to lower its premiums by communicating to the insurance agency what its own managers know about the institution's net exposure to nontraditional forms of risk. Our goal must be to confront institutions whose risk-taking imposes unacceptable risks on FDIC and FSLIC reserves with a combination of reduced coverages and increased fees sufficient to move them back from the brink.

Although it is logically necessary that some reregulation take place, the question is whether the 1983 round of regulatory readjustments will be adequate. The purpose of reregulation may be framed as making the FDIC and FSLIC act more like *private insurers,* so that they better protect their and taxpayers' economic interests and make uninsured depositors and stockholders bear more of the risk inherent in deposit-institution operations. Successful reregulation must administratively expand opportunities for troubled individual institutions to experience runs and even to fail.

The reregulation needed must include some or all of six basic changes in federal deposit-insurance contracts. The reader might view these proposals as column headings in a Chinese menu of nutritious reregulation.

1. *Full disclosure of adverse information*: Movement toward re-instituting market-value accounting for deposit-institution loans and investments can be justified as a cost-effective scheme for raising the implicit premium on deposit insurance in a risk-sensitive way. The most attractive aspect of this approach is that it lets market forces act as the arbiter that conducts risk assessments and sets risk premiums. In a world where declines in market value are not papered over by book-value accounting, deposit-institution managers who are tempted to pursue unregulated risks would know that they face quicker and more extensive damage to their careers when and if these risks go awry.

   Investors in deposit institutions and coinsuring depositors (those that are less than fully insured) deserve best-efforts estimates of the risk exposure and changing market value of the assets and liabilities that deposit institutions book. To produce such estimates, one need employ concepts no more sophisticated than present-value calculations. Hand-held calculators now permit any literate person to carry out present-value calculations. Market discount rates to use as inputs for these pre-programmed computations can be collected from secondary markets, supplemented where necessary by insurer-arranged auctions of similar assets, called precisely to generate market estimates of the value of questionable assets.
2. *Recalibration of insurance coverages*: The pattern of coverages must be altered to generate information on clients' own perceptions of the benefits from insuring different kinds of risk and of their willingness to pay for alternative forms of coverage. As a strategy for assembling information with which to improve the rating process, I would recommend three changes in contract provisions:
   a. Lowering the basic coverage per account (say to $10,000), with future limits indexed for inflation to make it less easy to reintroduce the real value of this coverage into the political arena.
   b. Differentially pricing successive layers of supplementary coverages (offered, say, in $10,000 slices) and adjusting these prices in accordance with market principles.
   c. Introducing provisions for deductible and coinsurance elements into this supplementary coverage. These elements could include provisions imposing additional penalties on stockholders of a failed deposit institution, as was the practice in the days before federal deposit insurance existed.
3. *Risk-rated explicit premiums*: These are needed to relegate implicit premiums on *recognized* forms of risk-taking to a lesser role. Opponents of this change emphasize that setting explicit premiums is a difficult task. However difficult it may be, it is not impossible. Private insurance companies contemporarily price many exotic

forms of risk, including the dangers of divorce, cancer, tax audits, and space debris. What is impossible is permanently maintaining a system that insures risk borne by deposit institutions at a price that lies far below the return offered in capital markets for risk-bearing services.

Because risk-sensitive pricing is a hard task and requires considerable adaptive efficiency, it seems dangerous to assign the function wholly to government officials. This leads to the fourth point in my program.

4. *Meaningful opportunities for private competition in deposit insurance*: To introduce competitive discipline, it is necessary to provide opportunities for private firms to issue or reinsure at least some layers of supplementary deposit-insurance coverage. Authorities must invite into the contract-design and contract-pricing process decisionmakers whose only stakes are economic—parties whose jobs and firms can and will be wiped out if they issue contracts that fail to make it each client's own best interest to keep its risk exposure under prudent bonds.
5. *Expanded opportunities for deposit-insurance agencies to manage their risk exposure*: Deposit-insurance agencies need enhanced rights to take timely action to cancel insurance coverage or to foreclose on the bank's charter before an institution's net worth is exhausted. The point is to stop institutions that are insolvent, de facto, from being permitted to make endgame plays with FDIC and FSLIC (i.e., taxpayers') money. Strengthening these rights could occur in many ways, though the logically most attractive approach—which is to consolidate federal deposit-institution regulatory functions in federal deposit-insurance agencies—would be resisted by officials of the Federal Reserve System.
6. *Statutory constraints on authorities' ability to bail out insolvent deposit institutions and deposit-insurance companies.* Deposit insurers must make their implicit guarantees of uninsured liabilities less perfect. This requires politicians to tie themselves to the mast of economic discipline so that (in the manner of Ulysses) they can resist the siren call of short-sighted opportunities for individual bailouts. First, deposit-insurance agencies should leave the short-term responsibility for stabilizing the financial system wholly in the hands of the Federal Reserve, acting in its capacity as lender of last resort. Bailout responsibilities should not be crammed into the mission statement of federal deposit-insurance agencies. Second, except perhaps in the event of a bona fide crisis (defined, say, by the condition that 10% of aggregate deposit-institution assets have been involved in failures within the last 12 months), even the Federal Reserve's capacity for bailing out *insolvent* institutions needs to be constrained.

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(Revised)

Commerce, Consumer, and Monetary Affairs Subcommittee
House Committee on Government Operations
March 14, 1984

STATEMENT ON PROPOSED DEPOSIT-INSURANCE LIMITS FOR BROKERED DEPOSITS

Edward J. Kane*

Thank you, Mr. Chairman. I wish to congratulate you and your committee for scheduling timely hearings on this important issue in deposit-insurance reform.

My testimony this morning seeks to accomplish three tasks: first, to identify the benefits of CD brokerage; second, to explain the policy problem they raise under the current system of subsidized deposit insurance; and third, to analyze the distributional and efficiency effects of the proposed FDIC and FSLIC solution to this policy problem.

Economic Benefits of CD Brokerage

In a world in which deposit insurance was properly priced and administered strictly in accordance with economic rather than political principles, CD brokerage would perform the wholly laudable function of perfecting interregional competition for time and savings deposits. CD brokers would merely reduce the implicit and explicit costs to depositors and deposit institutions in different regions of lining up and transacting the best deal possible. Both for disadvantageously located depositors and for disadvantageously located deposit institutions, CD brokers lower barriers to entry into national money markets. Deposit institutions that tried to offer their depositors less than the market rate on time or savings funds would lose customers to CD brokers. Similarly, sound deposit institutions with a sudden need for liquidity would not have to bid up their offering rate above the interest rate in the nationwide market.

In a word, CD brokers increase transactional efficiency on both sides of the deposit market. Their activity serves to integrate regional transactions into a national market in which the law of one price can hold sway.

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*Everett D. Reese Professor of Banking and Monetary Economics, The Ohio State University.

The Policy Problem

Even in our world where deposit insurance is subsidized and politically administered, transactional efficiency is in and of itself a good thing. The problem is that increased transactional efficiency applies equally well to governmentally unsubsidized and governmentally subsidized transactions.

Customers have always had the option of circumventing limits on accountholder coverage by opening up separate accounts in different deposit institutions. However, when they do this without a broker's help, they incur substantial shopping and other transactions costs that limit the extent to which setting up multiple relationships is economic behavior. Multiplying one's insurance coverage in this way generates expenses that make the extraction of deposit-insurance subsidies about as efficient as extracting dust from a carpet with a broom. If transactional inefficiencies could be eliminated, arbitrageurs could draw unintended subsidies from the deposit-insurance system with the ease of a well-functioning vacuum cleaner. Officials are right to worry that CD brokers make it possible for sharp customers and deposit-institution managers to extract unintended subsidies out of our nation's actuarially unsound deposit-insurance system with unprecedented ease and in potentially unsustainable amounts.

One fear is that managers of failing institutions have virtually nothing to lose by planning to bid for huge amounts of brokered funds and to invest the proceeds into very risky projects. If these risky projects pay off, the institution would be saved. If not, it was going to close anyway. To establish a baseline frequency for such end-game plays, the FDIC reports that roughly 16 percent of total deposits in the 72 commercial banks that failed between February 1982 and October 1983 were brokered funds.

If end-game plays were the only kinds of risk that federal deposit insurance subsidized, brokered deposits would present only a minor threat to deposit-insurance reserves, one that could be controlled in a more sharply targeted fashion.

The greater problem is that every dollar of deposits is insured for 1/12 of one percent, an amount far less than even a well-managed institution can earn by investing the proceeds in reasonably risky projects.

Under current arrangements, regulator capital-adequacy requirements and supplementary sanctions against specifically disapproved forms of risk-taking serve as additional implicit premiums that are imposed to limit the riskiness of individual institutions. However, this system of risk rationing cannot penalize managers for taking risks whose dangers deposit-insurance bureaucrats have not yet identified or are (like commercial-bank loans to less-developed countries and interest-rate risk taken by mortgage-lending thrift institutions) for political reasons unable to sanction. Opportunities always exist for an insured institution to arbitrage the difference between FDIC and FSLIC insurance premiums and risk premiums on lending opportunities. Attempting to arbitrage such deposit-insurance subsidies explains both why during the 1970s and even into the 1980s thrift institutions continued to make so many fixed-rate mortgage loans and why commercial banks made so many questionable loans to developing countries.

In the long run, market forces shift deposit-insurance subsidies forward to borrowers and backwards to depositors. Shifting means that interest rates earned on fully insured brokered CDs tend to be higher than they would be if deposit institutions could be coaxed into putting them into unsubsidized opportunities.

The Solution Proposed by the FDIC and FSLIC

The operative policy questions are how to bring the aggregate deposit-insurance subsidy back under control and who should bear the costs of adjustment. On its surface, the FDIC-FSLIC proposal to limit deposit-insurance coverage to $100,000 per broker per deposit institution looks like regulatory overkill. Spokespersons for the CD-brokerage industry have carefully nurtured this propagandistic view, maintaining that imposing such a limit would virtually knock them out of the CD-brokerage game.

If this were true, any good economist (something I strive always to be) would have to condemn the FDIC-FSLIC proposal as cutting too wide a swathe. Barring important competitors from entering specific markets is seldom a promising way of establishing economic efficiency. On the contrary, the modern theory of industrial organization emphasizes the desirability of minimizing barriers to entry into any market as a way of seeing that even competitors in highly concentrated markets have an incentive to charge competitive rather than monopolistic prices.

But the FDIC and FSLIC are not proposing to proscribe deposit brokerage. We must ask ourselves whether letting themselves be knocked out of the game is the best way that CD brokers can respond to the proposed rule. Spokespersons for the brokerage industry insult our intelligence in proclaiming that it is. Clearly, the industry has the option of self-insuring their customers or purchasing supplementary deposit insurance from private sources. Although the resulting insurance costs would have to be divided between brokers and the buyers and sellers of brokered CDs, it is not inherently more unfair to let the direct users of these services bear the insurance costs than it is to impose them on the general taxpayer.

Of course, authorities could control deposit-insurance subsidies available to brokered CDs in ways that would not place so large an adjustment burden on the CD-brokerage industry or its particular customers. The best policy would be for the FDIC and FSLIC to adopt risk-rated insurance premiums, a move which would have the further advantage of curtailing a great deal of the other turmoil currently besetting the contemporary financial-services industry. However, deposit-insurance bureaucrats have traditionally claimed that such premiums would be terribly difficult to calculate. Short of this, basic accountholder coverages could be reduced (say) to $10,000 or an individual accountholder's deposit-insurance coverage could be made subject to a cumulative lifetime ceiling of (say) $100,000 in the same way that most major-medical policies are currently written. Either move would be sufficient to establish incentives for brokers and depositors to care about the riskiness of the portfolio policies of the institutions in which they place brokered money.

However, once it is recognized that it would be uneconomic for a $100-billion CD-brokerage industry to allow itself passively to shrink into nothingness, the FDIC-FSLIC proposal may be seen as a long-overdue first step toward the rationalization of deposit-insurance pricing. If adopted, the proposal will create a sizeable demand by would-be owners and issuers of brokered CDs for supplementary deposit insurance from private sources. Whether serviced by third-party insurers or through self-insurance of customer accounts by prestigious brokers such as Merrill Lynch, this demand will be serviced. Once this occurs, risk-bearing incentives for participating deposit institutions will be altered drastically. Instead of being encouraged to reach out for all the risk they can slip by government examiners, deposit-institution managers will find themselves able to reduce their insurance premiums (and therefore to increase their access to brokered-CD markets) by following conservative principles of portfolio management. Deposit institutions ready to follow principles as conservative as those followed by money-market mutual funds would have to pay hardly any fees at all. Learning to live with private forms of deposit insurance should put to rest the alleged impossibility of establishing and administering risk-rated premiums for deposit insurance, revealing claims to this effect as the self-interested canards they have always been.

LOYOLA UNIVERSITY OF CHICAGO

GEORGE G. KAUFMAN
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April 16, 1984

Senator Jake Garn
Chairman
Committee on Banking, Housing, and
Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Garn:

In response to your letter of April 11, I provide below my answer to your question.

Question: You state on page 5 of your written testimony that, in your view, underwriting commercial paper is not a permissible activity for banks. Would you recommend that this committee pass legislation stripping banks of the power they already have in this area? If so, can you document abuses or problems in this area that have led you to this conclusion?

Answer: My preference for including commercial paper as a nonpermissible activity is based on my belief that such paper is really a security that is similar in all respects to other corporate debt securities but has a shorter maturity. Thus, the same potential conflicts of interest that are hypothesized to exist for corporate debt securities apply equally well or poorly for commercial paper. Commercial paper should not be treated any differently than other corporate debt securities. While I am not a lawyer, the Board of Governors' tortured reasoning that commercial paper is really a business loan and not a security appears to me as the perfect example of the definition of tortured reasoning. The Board's ruling is currently under consideration by the U. S. Supreme Court, and I recommend that no legislation be enacted until after the Supreme Court has made its determination.

Sincerely,

George Kaufman

George G. Kaufman

rk

RESPONSE TO WRITTEN QUESTION OF SENATOR GARN

FROM ALMARIN PHILLIPS, PROFESSOR, WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Question for Professor Phillips

Your statement supports interest payments on reserves because this would give the Federal Reserve a new and useful tool to use in implementing monetary policy. Professor Kaufman urges elimination of reserve requirements altogether. Which would be better: (1) no reserve requirements or (2) reserve requirements on which interest is paid with the Federal Reserve having discretion over the rate paid?

ANSWER TO QUESTION FOR PROFESSOR PHILLIPS

There is less difference between Professor Kaufman and me than may be apparent. If interest were paid on reserves, reserve requirements as we now know them would become unnecessary and, in fact, undesirable. In the absence of mandated reserves and with interest being paid on reserves held with the Federal Reserve, efficiency considerations would lead many institutions to maintain private interbank deposits rather than Fed balances to obtain clearing services and other reserve functions. Nonetheless, some institutions would hold Fed balances and the aggregate quantity of these balances would continue to be subject to Federal Reserve control.

More pointedly, if interest were paid on Fed balances, reserve requirements would cease to be important and should be phased out. I suspect Professor Kaufman pretty much agrees.

The **Chairman**. I have one more witness so if we can have as little commotion as possible as we change witnesses, I would appreciate it. Thank you very much, gentlemen.

Next I'd like to invite to the witness table J. Robert Hunter, president, National Insurance Consumer Organization of Washington, D.C.

STATEMENT OF J. ROBERT HUNTER, PRESIDENT, NATIONAL INSURANCE CONSUMER ORGANIZATION, WASHINGTON, D.C.

THE EMERGING FINANCIAL SERVICES INDUSTRY

Mr. Chairman and Members of the Committee: There has been great debate regarding the fall of the barriers between financial service providers. What has been lacking in the debate until recently is what is best for the consumer of these services. You are to be congratulated for opening the debate broadly to get input from those of us who represent, to the best extent we can, the public view.

I am Bob Hunter, President of the National Insurance Consumer Organization (NICO) and a former Federal Insurance Administrator, in which role I appeared before this body on many occassions, with fond memories.

In seeking to protect consumers, there are several major questions that must be asked:

1. Should banks be allowed to underwrite and/or sell insurance?

2. If so, who will regulate?

3. How will consumers get good quality information on service levels and prices, given a complex array of new products which may be developed as competition increases from new entrants?

4. What new consumer problems might arise, such as tie-ins?

5. Will there be significant concentration of financial resources if financial services can be performed on a one-stop basis?

FINANCIAL DEREGULATION

I would like to firmly state that it is NICO's belief that the barriers between financial institutions should come down. There is no justification, in our view, for prohibiting competition among concerns that meet economic and other standards for such activities. This is not to say that there should not be careful consideration of ways to control potential abusive practices, but it is to say that once those structures are worked out and in place, no impediments to competition should be allowed to exist. Specifically, I mean to say the banks should be allowed to come into insurance. NICO therefore supports passage of S.2181, with some amendments that I will later describe.

In an earlier report I submitted to the National Association of Insurance Commissioners (NAIC), following several years of research, I stated: (1)

> Entry into the agency writing (insurance) business is relatively easy, but entry into the direct writing business is not. Entry barriers are inherent in both the economics of direct writing and in the legal barriers resulting from old common-law rules. Direct writing requires an extensive distribution system whether through employees of exclusive agents, and a substantial public-name recognition. This all requires substantial initial funding.
>
> A legal barrier, cited by Joskow, is the common-law rule that the 'property rights' of an insurance consumer belong to the agent, not the company, so that an existing agency company cannot move with its existing insureds into the direct writing business.(2)
>
> Indeed, the Insurance Company of North America (INA) attempted to enter the direct writing field but was forced to give up the attempt when its agents threatened retaliation just a few years ago. Consequently, entry into the dominant part of the industry, the part marked by relatively high concentration for private passenger auto insurance, for example, is not easy. The ease of entry into agency writing benefits consumers only if new entrants can make their presence felt at the consumer level through price and other competition. To the extent that agency writing companies use or track bureau rates, competition from this segment of the industry is reduced; it is also reduced by resale price maintenance, inadequate consumer information, reverse competition, and investment income underwriting.

Banks can enter at the direct writing level which is a potential boon to competition in insurance. Equity argues for the level playing field everyone seems to want, we add; it is simply inappropriate not to let some of the teams on the field. Insurance companies today own banks, many of them. Security dealers own banks and insurance companies. Insurance companies own securities dealers. Why should the banks be prohibited from doing what the other entities are doing? There is no justification for that. We therefore strongly urge that you enact S.2181 which will enable banks to participate in the selling of and underwriting of insurance. It is vital that they be allowed to both underwrite and sell so that the benefits of direct writing can be gained.

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(1) Investment Income and Profitability in Property/Casualty Insurance Ratemaking, John Wilson and Robert Hunter, January, 1983. NOTE: A copy of this 225 page report has been made available to your staff.

(2) Joskow at 404 citing National Fire Insurance Company vs. Sullard, 89 NYS 934 (1904).

REGULATION

This requires careful analysis. The problems of Baldwin-United make it crystal clear that the current state approach to insolvency regulation and protection for insurance consumers if an insolvency occurs is woefully inadequate.(3) NICO's preliminary feeling is that a federal FDIC-type insolvency mechanism for insurance may well be needed regardless of whether or not banks enter the insurance field, but considerable research and analysis is needed on this point. What is obvious is that the close involvement of state and Federal regulators working together on whatever arrangements will emerge is necessary.

It is our view that this emerging industry offers a unique opportunity for mature state regulation and mature federal regulation to come to grips with who can do what best in all areas of regulation. It is not a time for turf-grabbing, as is so commonly done by bureaucrats. It is quite acceptable to begin with a walled-off approach, and the bill's silence may be the best way to start. Someday soon, however, I see a time for thoughtful consideration of what sort of regulation should emerge. Certainly I can see and advocate state regulation of consumer complaints and those sorts of things which need to be done at local or state levels for banks and insurers. I can also see and advocate centralization of such activities as insolvency protection on an equal basis for all Americans, data collection and analysis and overview of electronic cash flow transactions as these multi-state and multi-national conglomerates come together to undertake more comprehensive financial enterprises. I see no need for a war between the Federal and state arenas of government. Both are here to serve the very same people and who can do what best should be the question, not who loses or gains turf. There should be no other consideration except the public good in making these determinations. The process for making the decision should begin, but I believe that S.2181 need not await these outcomes.

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(3) Some 20 states have no insolvency fund to cover the Baldwin situation. No state is pre-funded. One state has indicated that it would take 80 years to pay off if Baldwin goes under. The state insolvency funds are a crazy-quilt of protection for American consumers.

INFORMATION

How does the consumer choose, given an oncoming massive change in financial services and information? Choice is good but we all know that if a laboratory animal is placed in a maze of tremendous complexity with lots of choice to move around, the animal can become confused and what occurs is what they call cognitive dissidence and a kind of nervous breakdown on the part of the animal. Fortunately, we have ways available to us in this era to break down the maze. And those ways relate to the new technologies of home computers, cable TV and entrepreneurism at the frontier of information exchange. There is no doubt that there is a need emerging for a consumer information broker, and government should make it possible for such brokers to exist by assuring access to the information necessary to service the public. I envision the day where a person could walk into an office and for a few dollars could receive a listing of the ten cheapest insurance companies or banks or securities dealers with some information on service for those companies from an independent information broker. Indeed, information alone will greatly ease the tie-in problem. The bill should be amended to facilitate such activities. This means that information on the rates being charged and on the service levels needs to be collected by whatever government currently regulates and made available to parties who might be interested in computerizing such information. For your information, this would not impose additional record-keeping or paperwork on insurers and state insurance departments, except in a few states.

CONSUMER PROTECTION

The concern most obvious to insurance consumers is the potential for tie-ins. It has been stated that if banks came into the insurance business, they would use their financial leverage to require insurance of people who seek loans. Do not minimize the concern that consumers have about this practice. Indeed, the tie-ins that insurers themselves engage in are somewhat of a problem. For instance, it is quite common for an insurer to be willing to write an auto risk if the homeowners policy is also included. The problem requires careful consideration by regulators as to how to assure that these practices do not occur. Banks are not clean in their current activities. Credit life insurance is an abomination throughout most of the nation. But the successful control of rates in the state of New York shows that these practices can be mitigated by courageous regulation. However, most states have not been able to overcome the tremendous lobbying pressure of banks and other lenders, car dealers and insurance companies to mitigate this abusive practice.

On the other hand, banks have done well in supplying savings bank life insurance in several states. Historically, these insurances have been inexpensive, pro-consumer and without charges of tie-in practices. When we think about all lines of insurance, most of them do not relate to tie-ins. There is no tie-in if a bank sells health insurance that I can see. The tie-ins on car loans and home loans would be at the first policy term and agents and others would be free to compete for renewal policies even if an initial tie-in occurred. But even the initial tie-in can be avoided.

NICO does not minimize the potential for lender abuse regarding tie-in practices. We agree with the protections proposed in Section 107 of S.2181, but suggest certain strengthening amendments be added:

- require that the notice that insurance can be bought elsewhere be very clear and precise and in bold, colored print;

- require that the notice be sent out a second time when the policy is delivered, for certification by any borrower that he or she understood what the notice means;

- have the cooling-off period run from the date of delivery of the policy and shorten it to 15 days (it is our experience that consumers act at once if it has a 15 day period, but tend to put it off and forget it if a 30 day period is granted);

- require information necessary to facilitate information brokerage operations (discussed above); and

- that these protections be extended to current credit related insurance sales, such as credit life insurance.

CONCENTRATION

Will there be undue concentration of economic power if financial services are merged? Again, I do not minimize he potential for concentration. We think significant concentration in insurance is inevitable whether or not financial service industries come together. I believe it must happen as the insurance industry becomes more efficient. Thousands have already been laid-off by insurers that have merged lately. There are hundereds if not thousands of inefficient insurance companies able to continue to exist because of the lack of meaningful competition in the insurance business under what the Justice Department and President Ford's Commission on Anti-Trust Laws and Procedures felt is an overly broad anti-trust exemption under the McCarran-Ferguson Act. I believe that instead of 5,000 insurance companies as we have today there will only be 500 to 1,000 by the year 2,000 even if there is no financial service integration. Because of the difficulty in entering the direct writing business and the large price advantage these few direct writers have, concentration has been increasing in the property/casualty insurance industry, particularly auto insurance, for at least three decades. After thirty years, the trend has produced the predictable result. Major lines of insurance are far more concentrated than in the 1940's, and many state markets are concentrated at oligopoly levels.

Current data indicate uniformly higher levels of concentration compared to the concentration levels reported a decade ago. As shown below, the 4-firm state market share is significantly higher than 10 years earlier, and most states have 4-firm shares in excess of 50% for one or both auto lines:

Average 4-Firm Concentration Ratios

	Homeowners	Auto Liability	Auto Physical Damage
1970	32.6%	39.2%	37.8%
1980	43.6%	49.8%	49.5%

Also, in contrast to circumstances ten years ago, today most homeowners markets and almost all auto markets are sufficiently concentrated to conform to the traditional broad definition of oligopoly: (4)

Number of States With Oligopoly Markets

	Homeowners	Auto Liability	Auto Physical Damage
1971	16	20	30
1980	38	50	48

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(4) Kaysen and Turner have defined an oligopoly market as one where eight firms have 50% of the business, and 20 firms have 75% or more. These are referred to as the eight-and twenty-firm ratios.

The few states not concentrated in auto lines are smaller states where the markets fall short of being concentrated by only slight amounts. Kentucky (phys. dam., 55.5%/74.9%); New Hampshire (liab., 49.0%/80.1%; phys. dam., 46.5%/78.3%); North Carolina (phys. dam., 50.9%/74.6%).

Similarly, while there were no states with highly concentrated markets under a more strict test (5) in 1971, there are now 27 highly concentrated state-product markets: and 12 more are borderline. (6)

Number of Highly Concentrated States

	Homeowners	Auto Liability	Auto Physical Damage
1971	0	0	0
1980			
Very high	4	14	9
Borderline	2	5	5

The states that are highly concentrated in both auto lines include a number of major open competition states, such as California, (7) Michigan, and Virginia.

While more research is needed, I believe that concentration may be reduced and jobs saved (although changed) by the allowing of banks and others to come into the business of insurance given the thousands of banks with the potential to be competitive insurance providers.

Let me conclude by saying, with all due respect to the Senate and to you Mr. Chairman, that whatever you decide regarding the merging of financial services will not stop the inevitable merging of financial services because that's what the people tell us they want and because that's what the economics of the situation dictate.

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(5) Dr. Willard Mueller defined an oligopoly market as one with four- and eight-firm ratios of 50% and 70% respectively. Monitoring Competition at 26.

(6) A state is borderline if it falls short of the high concentration boundaries by a total of no more than 2 percentage points (e.g., 48/70, 49/69, or 50/68), so that at present trends it will cross the high concentration line by the end of 1982.

(7) The California data recognize the fact that two major insurers to not compete in each other's territories, and, for competitive purposes, they are treated as one. Even without that adjustment, California is highly concentrated in liability insurance under the strict test (55.0%/70.5%) and almost so for physical damage (55.1%/68.8%).

SUMMARY

I propose that you:

- maximize competitive pressures in insurance by allowing all competent bank providers to sell or underwrite insurance by enacting S.2181;
- initiate talks between state and federal agencies regarding regulation of integrated financial services, based upon who can do which functions best, not based upon turf;
- control tie-in sales through such standards as precise disclosure and cooling-off periods proposed in S.2181, but strengthened to include certification of consumer understanding of his or her rights;
- extend tie-in protection to currently sold credit-related insurance, such as credit life insurance; and
- facilitate information brokering to enable wiser shopping by consumers and reduce tie-in potential.

I will be happy to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. Hunter. You recommended that banks be permitted to engage in insurance activities and you suggest that there be Federal insurance for Baldwin-type situations. What about the arguments that Professor Kane and others have made that the deposit insurance system is underpriced and far too sweeping? In other words, why not a system that reduces the accountability of corporate managers?

IMPACT OF INSOLVENCY FUNDS

Mr. HUNTER. Well, it may be that the system itself needs some kind of accountability in it, sir. I can just tell you from looking at Baldwin that the system in place at the State level today is essentially not there. Twenty States don't have insolvency funds to protect against that situation. One State that does have an insolvency fund says it would take 80 years to pay off what they would owe if Baldwin did go insolvent.

What I'm concerned about is the victim of such an insolvency and all I can tell you is that the current system at the State level does not respond and even the Conference of Insurance Legislators in a recent report have indicated that there's a need for some sort of national system. They suggest it be done at the State level but that it be integrated and perhaps that would suffice, but the insurance insolvency area certainly needs to be strengthened somehow.

The CHAIRMAN. If banks were permitted through their holding companies to get into the insurance business, how would you anticipate that most of them would desire to get into it, as underwriters, brokers, direct writers, or other alternatives?

Mr. HUNTER. I would hope they would want to get in as direct writers because that's where the maximum efficiency and maximum competitive impact would occur. Obviously certain of them would probably start out as either agents or underwriters, most likely agents. I would believe over time that the economies and efficiencies of the situation would dictate that in order to be competitive they would have to go into the direct writing mode. That's what SBLI does.

The CHAIRMAN. What is your view of the Comptroller's recent ruling which permits national banks to lease space to insurance agents?

Mr. HUNTER. Well, I believe it's a step. Again, I think it's responding to the inevitable pressures of agents out there throughout the country meeting with banks and trying to arrange such activities, seeing the handwriting on the wall I believe, and the banks, of course, are wanting to get into the insurance business. So I believe it is a step toward what we see as inevitable, the integration of these services.

The CHAIRMAN. You think this is a middle ground, a step?

Mr. HUNTER. It's a step, but it doesn't get to the real efficient step of allowing the direct writing to occur, whereas your bill would.

The CHAIRMAN. Certainly in the property and casualty business there have been some recent problems. American Express certainly is having some difficulties with Firemen's Fund. Do you still feel this is a business banks should get into?

Mr. HUNTER. Yes. In our study which I presented to your staff, we show that the insurance business is a lower than average risk business and we believe that banks and anyone who meets the financial requirements of the States or others would put on them, reasonable requirements for reserves, reasonable requirements for capital and surplus and so on, would not risk their own money in an enterprise if they didn't do the kinds of study necessary to make it work. I believe any company could get into trouble. GEICO got into trouble. Banks have gotten into trouble. As insurance gets more competitive, I believe there will be more trouble, but I don't think that's a reason to stop the positive forces of competition.

That's why, along with it, I want to make sure there's an insolvency mechanism, but I think the country would be much better off with a system that was competitive and a lot of direct writing in the banks and other outlets. It would be a far more superior system.

CROSS-SELLING OF FINANCIAL SERVICES BENEFICIAL TO CONSUMERS

The CHAIRMAN. The banking witnesses testified that cross-selling of financial services was operationally more efficient and that it was cost effective and a benefit to their consumers. How price sensitive do you think consumers are for insurance?

Mr. HUNTER. Well, we sell certain information on insurance and we exist on our sales of small brochures on how to buy life insurance and the like. There's a tremendous interest in that sort of information. People do go to the lower priced situation. The standard question we get is: what is the price? They ask that before they ask what the service is. People say, give us five low-price companies and then tell us which one you think is good. That's the order of the questions. I think that information on price will drive prices down. It's happened in places like South Carolina when we issued a study on the pricing structures of all the insurance companies writing automobile insurance in South Carolina, the higher priced companies dropped their price. So there is a price sensitivity.

The CHAIRMAN. Is directly written insurance generally less expensive than insurance sold through agents?

Mr. HUNTER. It tends to be, yes, about 8 to 10 points.

The CHAIRMAN. Then what happens as far as any counseling or advice in comparison to the individual agent?

Mr. HUNTER. Well, some people want a lot of counseling and advice and that's fine, just as some people want to go to Bloomingdale's. I think there will always be a role for the counseling and there will be some people who just want price and less counseling. I think just as discount stock brokers offer discounts and yet they're there and some people continue to use a stock broker with full service. Others choose to go over to the discount and do their own research. I don't see any reason why the same kind of thing can't happen in insurance.

The CHAIRMAN. What kind of comparison would you make on claims service, for example?

Mr. HUNTER. It's our experience there are good and bad in both areas. It's our experience that through Consumers Union and other research and our own complaints that we get, it's our experience that the low-priced companies tend to be better service companies.

The CHAIRMAN. Quicker?

Mr. HUNTER. Quicker and U.S.A.A. for example, has probably the fastest claim service in the country and it's one of the lowest priced. Their philosophy of service is let's get rid of the claims and pay as fast as we can. They seem to maintain a very efficient system but it doesn't seem to relate to the price. I do not find a correlation such as the harder claims settlers being the lower price. In fact, if anything, it's slightly the opposite.

The CHAIRMAN. Maybe their theory is to get rid of them faster because it doesn't take as much added staff time for fighting claims.

Mr. HUNTER. I think that's right, but the consumer doesn't care why. The consumer has the check. That's what the consumer goes by.

The CHAIRMAN. Mr. Hunter, thank you very much. We appreciate your testimony and your full statement will be placed in the record.

Mr. HUNTER. Thank you.

The CHAIRMAN. The committee is adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

Statement of A. Royall Whitaker, U S Naval Academy Economics Department Concerning the Omnibus Banking Bill, with special reference to Federal Reserve interest payments on bank reserves other than demand deposit reserves.

Mr. Chairman, for a little over three years my principal non-teaching academic activity has concerned possible interest payments by the Federal Reserve to individual banks. My particular contribution has been to note, and to explore, the fact that such payments would constitute lendable excess reserves and would therefore serve as a source of monetary growth just as Open Market Committee purchases now serve. Although all my work has assumed (and advocated) interest payments calculated on the basis of the demand deposit reserves themselves (and I understand that you are considering other reserves), the conclusion that they would be lendable excess reserves holds regardless of the basis of calculation.

One of the consequences of that conclusion is that while reserve interest might be what Senator Proxmire once labelled a "bonanza" for the banks, it does not have to be. A second consequence is that although reserve interest could be balanced by a reduction in Federal Reserve payments to the Treasury, it does not have to be.

Effects on the Banks

Exhibits A, B, C, and D explore the first consequence -- the possible benefits to the banks of interest payments to them by the Federal Reserve. I have assumed such payments to be in theform of increases in the banks' accounts at the Federal Reserve, and have included such accounts together with the banks' vault cash, and nothing else, as "funds" held in satisfaction of demand deposit reserve requirements.

Funds	1,000,000	Demand Deposits	10,000,000
Loans	9,000,000		

EXHIBIT A. No lendable excess

Exhibits B, C, and D show possible responses to the receipt of $1000 of interest, all involving an immediate $1000 increase in M1 which can be offset by a corresponding decrease in open market purchases.

Funds	1,001,000	Demand Deposits	10,000,000
Loans	9,000,000	Retailed Earnings	1,000

EXHIBIT B. $1000 lendable excess

In Exhibit B, all $1000 of interest is lendable excess because demand deposits have not increased. This bank could make a new $1000 loan but it could also simply distribute a $1000 cash dividend to the stockholders. Such a distribution would increase M1, but it would also provide the bonanza that has been warned of. I assume the Congress would like to reduce and perhaps eliminate this effect, and therefore submit exhibits C and D.

Funds	1,001,000	Demand Deposits	10,001,000
Loans	9,000,000		

EXHIBIT C. $900 lendable excess

In Exhibit C, the interest has been balanced by the banks' crediting interest to existing demand deposit accounts - an immediate increase in M1. This increases required funding only $100, so that the bank still has $900 excess for profitable lending. Although this arrangement is not nearly as attractive to the bank as is the arrangement of Exhibit B, it is exactly as attractive as receiving the $1000 via an Open Market Committee purchase from one of its depositors, which have the same effect on the balance sheet. Details of the discussion will vary if time or other depositors receive the interest, but the general effect remains the same - the individual bank benefits as it would from an injection pf reserves via the open Treasury paper market.

Funds	1,001,000	Demand Deposits	10,000,000
Loans	9,000,000	Deposit Fund Reserve	1,000

EXHIBIT D. $1000 lendable excess

Exhibit D Suggests a new liability account of my own devising, a "Deposit Fund Reserve" (a true reserve as the term is ordinarily used in accounting) as the balancing item for Federal Reserve interest payments to individual banks. Because the entire $1000 is lendable excess this arrangement is slightly more attractive to the bank than is the arrangement of Exhibit C, but there is still no possibility of a direct payoff to the stockholders as there is in Exhibit B. There is also the possibility that a full $1000 reserve injection will not be required to generate the desired new lending; a $900 injection will do if it is all available for lending - that is, if none of it is tied up in Treasury paper held by middlemen.

In benefit to the banks, Exhibits C and D differ in kind from Exhibit B, but Exhibit D differs at most only slightly in degree from Exhibit D, and Exhibit C would affect the banks in the same way that open market operations have affected them for the past half centery. If you oppose Federal Reserve interest payments, you need not do so on the grounds of some new and unjust enrichment of the banks; if it would be unjust, it has been so for fifty years.

Effects on the Federal Reserve and the Treasury

The second consequence of central bank interest's potential as a source of monetary growth requires no further exhibits, only a little further discussion. Federal Reserve interest payments could be balanced by a reduction in its payments to the Treasury, which would increase the federal deficit and require the Treasury to increase its borrowing, thus either pushing up interest rates or requiring increasing open market purchases by the Federal Reserve.

Another possibility, however, is for the Federal Reserve to reduce its open market purchases to offset its interest payments dollar for dollar. The Federal Reserve's own balance sheet in that case would have to be balanced either by its taking the new Deposit Fund Reserves as an asset (against the possibility of "negative interest" or central bank charges) or by the devising of some new preemptive right of the Federal Reserve to demand legal tender at the Bureau of Engraving and Printing. Ultimately, either asset is as good as Treasury paper.

If you authorize the payment of interest by the Federal Reserve, I presume you would want to spell out whether you do or do not intend those payments to alter the division of new money, M1, between the Treasury and everyone else.

Recommendation

However, I respectfully urge you on two grounds to forbid the payment of interest by the Federal Reserve on funds held by banks on account of any liabilities other than demand deposits and the like. The first ground is that such interest payments would further complicate a situation which the Wall Street Journal once likened to trying to thread a needle while standing in a hammock. For example, we already have a frequent conflict between desired growth of M1 and desired behavior of yields on Treasury paper, and I have sought in this statement to show you the monetary (M1) implications, also possibly conflicting, of attempts to manipulate liabilities other than checkable deposits.

Second, and far more important, is the ground that interest payments based instead on demand deposits themselves could actually simplify the Federal Reserve's job and greatly increase its effectiveness. I hope to have an opportunity to present such a proposal to you in a separate statement.

4 April 1984

COMPETITIVE EQUITY IN THE FINANCIAL SERVICES INDUSTRY

PART III

WEDNESDAY, MARCH 21, 1984

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Gorton, Hecht, Humphrey, Proxmire, and Cranston.

OPENING REMARKS OF CHAIRMAN GARN

The **CHAIRMAN**. The committee will come to order.

We continue the hearings today on S. 2181 and S. 2134, the financial institutions deregulation legislation.

Gentlemen, we appreciate you changing your schedules on short notice. Originally the hearing had been scheduled for 9:30. However, the President had requested a meeting with Senators this morning at 11 o'clock—if it had been anybody else, we would not have changed your schedules, but when the President schedules meetings we do tend to go to them. So we appreciate you changing your schedule.

We have before us C. Todd Conover, Comptroller of the Currency; William M. Isaac, Chairman of the Federal Deposit Insurance Corporation; Edwin J. Gray, Chairman of the Federal Home Loan Bank Board; and Edgar F. Callahan, Chairman of the National Credit Union Administration.

Mr. Conover, would you like to begin.

STATEMENT OF C. TODD CONOVER, COMPTROLLER OF THE CURRENCY, U.S. DEPARTMENT OF THE TREASURY

Mr. **CONOVER**. Yes, I will, Mr. Chairman. I have a full statement and an appendix which I would like to have entered in the record.

The **CHAIRMAN**. We will include your full statements, all of you, in the record.

[The complete statement follows:]

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STATEMENT OF
C. T. CONOVER
COMPTROLLER OF THE CURRENCY
Before the
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
March 21, 1984

Mr. Chairman and members of the Committee, thank you for asking me to testify on S. 2181 and S. 2134, which both deal with reform of the legal framework governing the financial services industry. I will restrict my remarks to S. 2181, the Financial Services Competitive Equity Act. It embodies the changes proposed in S. 2134, but represents a more comprehensive approach, which I strongly support. My views are not necessarily those of the Administration.

The comprehensive deregulation contained in S. 2181 will strengthen our nation's financial services industry and will enable consumers to benefit fully from innovations in the industry. Today I will discuss how S. 2181 meets the need for continued deregulation and will also suggest some improvements to the bill. Specific comments on individual titles of the bill are included in an appendix.

I have testified on the importance of comprehensive deregulation on many occasions. Removing Regulation Q ceilings, and thus allowing depositors to earn market interest rates, has made it necessary for banks to seek new sources of earnings; however, most avenues to new earnings are still closed to banks. Today I would like to emphasize a point that is too often overlooked -- that consumers will be the primary beneficiaries of legislation granting financial service providers wider latitude to compete.

CONSUMER BENEFITS OF COMPREHENSIVE DEREGULATION

As the Committee considers expanding the permissible activities of financial service providers, I urge you to focus on the benefits that will accrue to consumers as a result of more vigorous competition. Despite what we sometimes hear, deregulation does not mean that commercial banks will come to monopolize the financial services industry or that small providers will be swallowed up or disappear. Rather it implies that the success or failure of any firm -- be it a bank, a thrift, an insurance company, a securities firm, or a real estate organization -- will depend on how well it meets market demand.

For that reason, I view S. 2181 as an impressive piece of pro-consumer legislation. Some of the consumer benefits that are likely to result from adoption of the bill are as follows:

- One-stop shopping for financial services. Deposit, loan, insurance, securities, and real estate services will all be available at a single location.
- A more varied menu of products. Individuals with differing needs will be served better through increased competition. For example, improved asset management accounts can be designed as a result of allowing affiliations between banks and securities brokers. Competition should lower the minimum balance requirements of these accounts (currently $10,000-$20,000), making them accessible to more consumers.
- New product innovations. With the ability to integrate different financial services into one package, product designers will have new freedom to creatively combine financial services in new and imaginative ways.
- Lower cost insurance and real estate products. Affiliations between depository institutions and insurance and real estate firms will increase competition and will result in more efficient distribution systems, thereby lowering consumers' costs.
- Increased flow of housing credit. Permitting banks to gather and pool mortgages and to sell mortgage-backed securities to all investors will facilitate the flow of credit to housing. Mortgages will become a more attractive instrument to a greater number of investors, and mortgage interest rates will become more competitive.

- Better services for small businesses. Banks will be able to design low-cost cash management services for small businesses by using their ability to offer interest-bearing checking accounts and mutual fund services.

- Stronger community institutions. By affiliating with one another, small, local providers of financial services such as small community banks, insurance agents, and local independent real estate firms will be better able to compete with large, nationwide organizations such as Merrill Lynch, Sears, and Citicorp. Thus individuals and small businesses will be able to obtain new products from community institutions familiar with local needs.

S. 2181 achieves these benefits by removing impediments to competition and by eliminating inequities in the regulation of institutions providing similar services. The consumer benefits noted above are made possible by the following provisions of the bill:

- Title I creates a holding company structure that permits the offering of a full range of financial services -- including deposits, securities, insurance, and real estate services -- by a single organization.

  It also introduces additional competition in the retail banking area by permitting the creation of consumer banks and qualified thrift lenders. Ownership of these institutions would not subject the parents to the activity restrictions of the Bank Holding Company Act or the Savings and Loan Holding Company Act.

- Title IV provides for the payment of interest on required reserves held against Super NOW and money market deposit accounts. This provision removes an implicit tax that falls on banks and thrifts, thereby allowing them to offer more competitive interest rates for deposits.

- Title VII provides for an override of state usury laws. Rigid usury ceilings tend to harm rather than help those who seek credit. Their removal would benefit consumers by enabling lenders to make loans within their states even when market interest rates are high.

- Title VIII permits the payment of interest on demand deposits, thereby removing one of the last remaining interest rate controls on deposit accounts. This provision would particularly benefit those small businesses that are ineligible for NOW accounts. It would also remove a competitive inequity between depository institutions and money market mutual funds in the competition for corporate accounts.

- Title X authorizes regional interstate banking arrangements. This would be a step toward removing all geographic barriers to competition. It would widen the number of banking alternatives for consumers and facilitate capital flows across state borders.

A SUGGESTED IMPROVEMENT TO S. 2181

Although S. 2181 provides substantial benefits to consumers of financial services, there is an important inconsistency in the bill's treatment of consumer banks and qualified thrift lenders. As proposed, ownership of either institution would not subject the parent company to bank or thrift holding company statutes. The amount of commercial lending permitted for the two types of institutions, however, is quite different. Consumer banks may have no more than five percent of their assets in qualifying small business loans, and may have no other commercially related loans. Qualified thrift lenders, on the other hand, may have up to 25 percent of assets in commercially related loans, regardless of the amount of their mortgage lending.

As a consequence, the bill skirts an important question: should nonfinancial firms such as steel companies or construction firms, or corporate underwriters be allowed to own federally insured depository institutions that engage in commercial lending? The answer given by S. 2181 appears to be yes if the depository institution has a thrift charter but no if the depository institution has a commercial bank charter. Yet, the public policy concerns are identical in both cases.

In my view, when a bank or thrift institution gathers deposits insured by the federal government, it is in the public interest to ensure that the institution's lending and investment decisions are made objectively. Thus, in allowing depository institutions to engage in nonfinancial activities -- or the underwriting of nonfinancial activities -- care should be taken to ensure that the institution cannot utilize its lending and investment function to serve its own or its parent's other interests.

The establishment of the consumer bank in S. 2181 embodies this concept. Although nonfinancial firms continue to be unable to own full-service commercial banks, they will be allowed to own banks that do not engage in commercial lending -- except for a minimal amount of small business lending. In this way, the danger of preferential lending is avoided.

I urge the Committee to apply the same limit on commercial lending to qualified thrift lenders. The public interest in limiting a nonfinancial enterprise's ownership of a commercial lender does not depend on whether the lender has a bank or thrift charter. The public is not well served when the rules governing similar institutions are needlessly inconsistent.

In addition to this limitation, I would support instituting further safeguards to ensure that a nonfinancial firm cannot utilize a consumer bank or a qualified thrift lender to benefit its other activities. Specifically, I suggest limiting the ability of these institutions to finance the sale of any of their parents' products.

THE IMPORTANCE OF MOVING AHEAD

Although I have stated some reservations about certain features of S. 2181, overall I strongly support this legislation. It is a comprehensive approach that does not cater to special interests. It will provide needed freedom to the financial services industry to expand choices and improve services to the consumer.

Because of its comprehensive and objective approach, it has opposition, especially from those who want to protect their own markets from outside competition. This is inevitable as we emerge from a heavily regulated environment to a more competitive one. We are all familiar with securities firms complaining about banks entering the brokerage business and banks decrying the efforts of others to offer close, but unregulated, deposit substitutes. Representatives of the insurance industry and independent real estate agents warn of inferior service or an ominous trend toward concentration any time an outsider attempts to enter into their line of business. These objections mask the real reason for their opposition -- they don't want the competition.

There will be short-term winners and losers from the reforms contained in S. 2181. But we cannot forget that the real beneficiary of this legislation is the consumer. It is consumers who win when the restraints are lifted and more competitors can vie for their patronage.

CONCLUSION

In conclusion, I want to emphasize the importance of acting soon on this comprehensive legislation. Inaction by the Congress would mean sanctioning a financial services industry characterized by legal inconsistencies and market inefficiencies. In particular, I ask you to consider the following:

- Does it make sense to allow Sears customers to obtain the services of a federally insured depository institution, a full-service brokerage house, a real estate agency, and an insurance firm all under one roof, while prohibiting most other depository institutions from entering into affiliations with these other types of financial service providers?
- Does it make sense to let the interests of the consumer take a back seat to industry efforts to protect their markets in determining the structure of the financial services marketplace?
- Does it make sense that market innovations made possible by recent technological breakthroughs are stifled by a statutory framework enacted over 50 years ago?
- Does it make sense that savings and loan associations are subject to less demanding capital requirements than commercial banks but have substantially more latitude in product and geographic expansion than banks?
- Does it make sense that lawyers looking for ways to circumvent regulations are the primary business strategists rather than individuals who creatively seek to meet consumer demands?

Obviously, the answer to all of these questions is a resounding "No." Yet, questions such as these are raised by continued inaction. Congress has before it the opportunity to bring sense to the legal structure governing the financial services industry, and at the same time provide substantial consumer benefits. I urge you to move ahead with S. 2181.

APPENDIX

S. 2181: FINANCIAL SERVICES COMPETITIVE EQUITY ACT

Title I - Financial Institutions Competitive Equity

Title I would expand the permissible activities of bank holding companies and place the powers and regulation of bank holding companies and multiple savings and loan holding companies on a par. It contains many of the provisions of S. 1609, the Financial Institutions Deregulation Act (FIDA). In addition to FIDA provisions, Title I would also authorize consumer banks; impose geographic limitations on branching and interstate acquisitions; impose limitations on large bank and s&l holding company affiliation with insurance, securities and real estate firms; close the so-called South Dakota loophole; impose more stringent antitying provisions; and retain the unitary s&l holding company exception for "qualified lenders".

As I have indicated in this testimony -- and numerous times in the past -- we support the deregulation of the products and services that financial service providers may offer to their customers. We believe that Title I of S. 2181 is a significant step in this direction, as it expands the permissible activities of financial institutions through the holding company structure, thus providing these institutions with a layer of risk insulation.

In brief, our position with regard to the major features of S. 2181 is as follows:

- We support the new, expansive definition of "bank" for the purposes of the Bank Holding Company Act provided there is an exemption for consumer banks;

- We support the expanded securities, real estate and insurance powers for holding companies;
- We support the proposed antitying safeguards, but believe that they should apply to banks and thrifts alike;
- We support the closing of the South Dakota loophole, and believe the loophole should be closed also for activities other than insurance;
- We are opposed to the inconsistent treatment of consumer banks and qualified thrift lenders; we believe that full-service securities firms should be able to own consumer banks.
- We are opposed to the geographical restraints imposed on acquisitions of consumer banks and thrift institutions by bank holding companies;
- We are opposed to the proposed concentration limits.

Specifically, we have the following comments regarding the provisions of Title I:

Definition of bank and consumer bank. - The definition of "bank" in Title I closes, in part, the nonbank bank loophole which exists in the current definition of the Bank Holding Company Act. By including insured banks in its definition, the bill would subject to the Bank Holding Company Act all federally insured banks, even those that do not accept demand deposits or do not engage in commercial lending, although state-insured or uninsured banks and thrifts that engage in only one of the above-specified activities would continue to be exempt. In addition, the definition would specifically exempt consumer banks, as well as industrial banks, Morris Plan banks, industrial loan companies and similar institutions, that do not both make commercial loans and take demand deposits.

We support redefining a bank so as to include all federally-insured banks which are engaged in commercial lending. Conversely, institutions that do not use federally insured deposits to fund their commercial lending business should not be subject to the Bank Holding Company Act. Therefore, we support the exemption granted to "consumer banks" in this respect. The potential for abuses present when nonfinancial firms affiliate with commercial lending firms is not present in consumer banks.

We also support a statutory definition of "commercial loans". As experience has shown us, this definition is crucial, and Congress should indicate its intent in clear and unambiguous terms in this area. In particular, we endorse the definition of commercial loans now proposed in S. 2181; it provides a well-balanced approach to the issue.

We are concerned that the exemption granted to industrial banks -- as currently worded in Title I -- leaves open the possibility that these institutions will become the "loophole" organizations of the future. One reading of the bill would lead us to conclude that, unlike consumer banks, industrial banks (or Morris Plan Banks or industrial loan companies) would be exempt of the definition if they were to forgo either commercial lending or accepting demand deposits. Another reading of the bill would indicate that industrial banks could be exempt even if they were to both make commercial loans and accept demand deposits. I fail to see any rational basis for such a distinction and believe that industrial banks should be subject to the same rules as consumer banks.

It is not clear whether the term "similar institution", as used in the exemption (p. 6, line 25), refers to consumer banks, industrial banks, and Morris Plan banks, or only to industrial loan companies. We would be happy to provide to the Committee drafting assistance to clarify the provisions regarding the definition of "bank" and the related exemptions.

Finally, I note that the exemption granted to consumer banks and their parent companies in Title I would not lift the prohibitions of the Glass-Steagall Act regarding affiliations between securities firms and banks. Consequently, a company which engages in the securities activities prohibited in 12 U.S.C. 377 would not be able to own directly a consumer bank which is a Federal Reserve member bank. In my opinion, there is no reason why a full-service securities firm should not be allowed to own a consumer bank. Inasmuch as consumer banks cannot engage in commercial lending, the concerns of the Glass-Steagall Act regarding the separation of commercial banking and securities business are not raised. Again, we would be pleased to assist in drafting an appropriate statutory amendment.

Qualified Thrift Lender. - In my testimony, I have already commented on the concept of qualified thrift lenders and the arbitrary and inconsistent treatment of these institutions and consumer banks. In addition, the same inconsistency is repeated in the treatment of service corporations. On the one hand, the bill creates "Depository Institutions Service Corporations", providing through such service corporations narrow but equal powers for all depository institutions. On the other hand, the bill retains the current, more liberal service corporation option for the qualified thrift lenders -- whether or not they have a parent company -- and for all mutual thrifts. Thus, virtually the entire thrift industry is exempt from the proposed "equalization" of service corporation authority. This provides an additional incentive to shop for the most permissive charter.

There also appears to be a technical oversight in the qualified thrift lender provisions. As currently written, the bill exempts parent companies of qualified thrift lenders from the provisions of subsection (c) of 12 U.S.C. 1730a. Subsection (c) includes a provision prohibiting savings and loan holding companies and their subsidiaries from engaging in any activity which would evade the laws or regulations applicable to thrift institutions (and it currently applies to unitary savings and loan holding companies). Thus, under Title I, the parents of qualified thrift lenders would no longer be explicitly prohibited from evading the applicable laws. To avoid such a broad exemption, the bill should be amended to exempt qualified thrift lenders from the provisions of subparagraph (c)(1)(B) of 12 U.S.C. 1730a, and paragraphs (c)(2) and (3) -- not subsection (c) in its entirety.

Geographic restrictions. - Title I contains a number of provisions imposing geographic limitations on acquisitions by bank holding companies. First, it applies a geographic limitation along the lines of the Douglas Amendment to the companies that own consumer banks. Second, the bill imposes geographic limitations on the acquisition of thrift institutions by bank holding companies, as well as on the subsequent branching of such acquired thrifts. In both respects, the bill contains some ambiguities and inconsistencies. For instance, it does not clearly indicate whether the Douglas Amendment would apply to a non-bhc that owns consumer banks. And, the restrictions obviously do not apply to the acquisition of industrial banks.

As I have indicated in my testimony, I am opposed to geographic restraints. The existing and proposed new restrictions are counterproductive to the process of deregulating financial services. Therefore, I believe that the proposed limitations should be eliminated.

As a footnote, we also note that the provision imposing geographic restrictions suffers from a technical deficiency. Literally, it would subject companies owning consumer banks on July 1, 1983, to a Douglas-type limitation. This could be read to imply that companies that acquired consumer banks on or after July 2, 1983, would not be subject to any geographic limitation. This ambiguity can be remedied by adding the words "or after" immediately preceding "July 1, 1983".

Size limitations. - Title I would impose a limitation on the size of combinations of banks or bank holding companies and other financial services firms. We are opposed to arbitrary size limitations which are not based on any clearly identified objective. The only thing that such restrictions will do is limit the flexibility of financial companies to serve the marketplace adequately and efficiently. I fail to see any need, beyond the scope of antitrust laws, to require limitations on potential concentrations between depository institutions and other financial servicers.

In my view, combinations of large firms that are not in the same line of business do not raise public policy concerns. With regard to nonfinancial industries and even nondepository financial industries, it is generally accepted that the antitrust laws adequately guard against detrimental effects of undue concentrations. It is also generally recognized that consolidations across industries do not raise similar concerns, particularly where the applicable statutes guard against coercive tie-in sales.

Additional antitying prohibitions. - Title I would impose restrictions on the insurance sales activities of bank subsidiaries of bank holding companies. These restrictions are intended to create safeguards for the consumers of insurance services. Among other things, the bill would require a bank to provide a written explanation that credit insurance may be purchased from an independent insurer; to give a written commitment that credit will be granted, before soliciting insurance; not to reject unreasonably insurance provided by an independent insurer; and to provide a 30-day cancellation period for credit insurance.

We support these provisions of S. 2181. We have consistently supported safeguards against possible conflicts of interest between banks and their nonbank affiliates. However, the proposed safeguards do not apply to thrifts or other institutions which are not subject to the Bank Holding Company Act. In the interest of broad consumer protection and consistent regulation of various depository institutions, they should be made applicable to all financial servicers.

Bank service corporations. - Title I would repeal the existing bank service corporation statute and create, instead, "depository institutions service corporations" where the service corporation powers and the investment authority would be essentially the same for banks and thrifts.

In many respects, the powers of the service corporations, as proposed in Title I, are similar to those contained in the statute which existed before the amendments effected by the Garn-St Germain Depository Institutions Act of 1982. However, unlike the old statute which allowed other than banks to invest in bank service corporations, Title I requires that all of the stock of the service corporation must be owned by one or more depository institutions. We believe that such an additional restriction would unnecessarily impede the capitalization and funding of the service corporation.

In addition, we note that section 2 of the proposed service corporation statute contains an apparent technical error. As currently written, the statute limits investments in "Depository Institution Service Corporations" to 10% of the financial institution's paid-in capital and unimpaired surplus. In the next sentence, similar investments are limited to 5% of the institution's total assets. We assume that the 10% limit was intended to apply to investments in any one service corporation. An appropriate correction should be made to that effect.

Real estate activities. - Title I would permit bank holding companies and their subsidiaries to engage in real estate brokerage, as well as real estate investment and development within certain limitations. As we have indicated previously, we support the deregulation of banks' activities in this area.

However, we believe that the bill's prohibition of real estate construction is unnecessary. First, the existing statutes and the proposed new real estate powers would not, as a general rule, authorize banks to enter construction business. Second, there are limited exceptional circumstances (such as attempts to maintain or dispose of foreclosed properties), where it may be necessary for banks to undertake some form of construction.

South Dakota loophole. - Title I would preempt states from permitting state banks to engage in insurance activities outside the state on a different basis from that permitted inside the state. This provision would close the so-called "South Dakota loophole". We believe that such a loophole is inequitable, and support this provision to close it. In addition, we believe that such loopholes should also be closed for activities other than insurance.

In this context, let me hasten to emphasize that my concern about the "South Dakota loophole" does not apply to a situation where a state permits state-chartered banks to engage in new activities within that state on the same terms as those for out-of-state activities. We believe that such measures are legitimately within a state's rights and should not be subjected to a veto by a federal bank regulator.

Streamlined bhc procedures. - Title I would significantly simplify the bhc reorganization procedures in situations where the shareholder of the bank receives substantially the same interest in the newly-formed bhc. In effect, these provisions would make it easier for banks to form holding companies, which, in turn, could establish securities or other non-bank affiliates. We fully support these efforts to minimize the complexity of the existing regulatory processes. We also believe that the bhc formation could be further streamlined to reduce the time and money required especially in instances where compliance with merger procedures is necessary. We will provide you drafting language on these additional and simplified procedures in the near future.

Title III - Bankers' Banks

In addition to a number of technical conforming amendments, this title would authorize bankers' banks to provide services to holding companies of depository institutions, their subsidiaries and personnel. It would also confirm that bankers' banks may invest in export trading companies engaged in the full range of services permitted to other bank-affiliated trading companies. In this respect, Title III would harmonize the provisions and terminology of the Export Trading Company Act of 1982, Pub. L. 97-290, and the Garn-St Germain Depository Institutions Act of 1982, Pub. L. 97-320, as they affect bankers' banks.

We support these amendments and urge their enactment as part of S. 2181 or as an independent bill. In addition, we suggest that Congress consider authorizing bank holding companies to invest in bankers' banks. Such an amendment would further strengthen the capital base of those institutions.

Title IV - Interest on Reserves

Title IV would direct the FRB to pay interest monthly on reserves held against money market deposit accounts (MMDAs), super-NOW accounts, any other new transaction account authorized by the DIDC, and comparable credit union accounts.

The OCC strongly supports the payment of interest on all required reserves, not only those held against MMDAs and super-NOW accounts. Noninterest-bearing reserves represent an unfair tax on depository institutions, and during periods of high interest rates this tax can be especially burdensome. The imposition of noninterest-bearing reserve requirements also places depository institutions at a competitive disadvantage compared to nondepository providers of financial services. For example, money market mutual funds, which also offer transaction accounts, escape reserve requirements by using zero-balance checking accounts at depository institutions.

As a technical comment, we note the bill is ambiguous as to the types of reserves that earn interest. (P. 67, lines 5-12.) On the one hand, section 402 appears to imply that interest will be paid on deposits in an Earnings Participation Account. On the other hand, the next sentence then states that interest earnings shall be paid "to the depository institutions which maintain reserves pursuant to this paragraph" (*i.e.*, presumably also vault cash reserves). I suggest that the language be clarified to indicate unambiguously the types of reserves that will earn interest.

Title V - Consumer Leases and Rental-Purchase Agreements

This title would consolidate the disclosure provisions for consumer leasing transactions and enact, for the first time, disclosure requirements for rental purchase agreements. As such, this title would not significantly affect national banks because, under existing law, their leasing authority is limited. National banks may engage in personal property leasing only to the extent it is incidental to the "business of banking", such as lending of money.

Nevertheless, we urge the inclusion of a stronger federal preemption provision to alleviate the current confusion regarding the applicability of similar provisions contained in state laws. The provision in Title V is rather narrow, preempting state laws only to the extent they are "inconsistent" with the federal law. The Federal Reserve Board is authorized to determine whether inconsistencies exist and whether the state law contains substantially similar requirements or gives greater protection and benefit to the consumer.

This type of federal preemption, however, does not address the problems of differences in characterization. Some state legislatures or courts have characterized the short-term or terminable consumer lease with ownership options as a purchase or a credit sale. The result is that state disclosure requirements designed for credit sales would be applicable to terminable leases and would not be preempted by this title.

Additionally, in some markets, complying with more than one state's disclosure requirements may be necessary, requiring the use and expense of multiple disclosure documents. Without a stronger federal preemption, such multiple compliance will continue to burden lessors and ultimately will result in increased costs to the consumer. One possible alternative would be to authorize the Board to consider whether the state law and multiple compliance unduly burden interstate commerce.

In this context, I also note that, in the past, this Office has supported an amendment to S. 1152 to expand national banks' leasing authority. To assure competitive parity between national banks and thrifts, we support an amendment similar to section 330 of Garn-St Germain Depository Institutions Act of

1982 that granted additional leasing authority to thrift institutions.

Title VI - Fair Deposit Availability

This title is designed to reduce the delay on the availability of checking account deposits to the consumer. To accomplish this objective, the title imposes four requirements on depository institutions: disclosure of general hold policies; an ANSI- or FRB-endorsement standard; notification of inability to pay on items of $250 or more; and computing of interest on deposits from the date of provisional credit to the depository institution. The title also includes provisions for enforcement and civil liability.

We strongly support the disclosure principle to promote increased consumer information on the availability of funds. Disclosure is an effective means of enhancing competition and ensuring that the consumer can make an informed decision in choosing among depository institutions. Many institutions already provide written disclosure of their hold policies when a transaction account is opened; many instruct their staffs to inform the consumer when a hold would be imposed on a particular item at the time of deposit. In a Banking Bulletin BB 84-8 (February 3, 1984), this Office reminded all national banks that such disclosure is consistent with the customary and prudent banking practices.

Likewise, the proposed requirement for the payment of interest to the depositor from the date of provisional credit to the bank appears equitable. Such payment of interest is both fair to the consumer and not unduly burdensome to the depository institution. As a competitive matter, many institutions already pay interest from the date of deposit or provisional credit, despite the difficulties of backing out interest on returned items.

On the other hand, we object to the notification requirement and the imposition of civil liability for non-complying institutions. The title requires payor banks to notify the depository institution of original deposit within 24 hours of insufficient funds for checks of $250 or more. Currently, under the Federal Reserve Banks' uniform policies, banks are required to provide notification for checks of $2500 or more within the time limits set forth in the Uniform Commercial Code (by midnight of the banking day following the day of receipt of the item).

In practice, the $2500 direct notification requirement has proven to be so unreliable that many institutions, despite the notification, are reluctant to charge back the depositor until the actual item is returned. Reliability and the practical application of the direct notification requirement will not improve by lowering the limit from $2500 to $250. Moreover, to apply the notification requirement to amounts as small as $250 would increase significantly the number of items to be "exception processed" and would result in a substantial burden on operations and expenses of depository institutions. Since such costs will be reflected in service charges, imposition of such a requirement at the $250 limit will be ultimately reflected in increased costs to the consumer.

Other less burdensome approaches to expedite the return check process may be to allow returns directly to the depository institution of original deposit, or to require a particular financial institution to act as a clearing house for all returns, or to amend the UCC to address excessive delays in the delivery of returns. These alternatives should be evaluated before imposing the proposed direct notification requirement.

The title would subject a depository institution to civil liability for intentional failure to comply with the requirements for disclosure or payment of interest. Although an institution would have "good faith" and "bona fide error" defenses, litigation of each alleged violation of the disclosure requirements would be costly and unnecessarily burdensome, and may encourage the filing of frivolous suits. We believe that supervisory enforcement of the relevant requirements will be a sufficient means of providing adequate consumer protection.

Title VII - Credit Deregulation and Availability

This title would permanently preempt state interest rate ceilings on business, agricultural and consumer credit. It would also provide states with a three-year period to override the federal preemption and to impose rate restrictions of any amount and in any form.

The OCC continues to support the federal preemption of state usury ceilings. Such ceilings are ineffective and counterproductive, distorting the workings of the marketplace and adversely affecting certain classes of borrowers as well as local economies. Instead of aiding weaker borrowers and encouraging local economic activity, usury ceilings tend to decrease extensions of credit and diminish such activity. The most effective means to ensure wide credit availability at affordable rates is through a strong, competitive financial system and sound national economic policies. By lessening existing restrictions in the financial marketplace as well as reducing inflationary pressures, overall interest rates will continue to decline.

Recognizing that states, traditionally, have had concerns regarding usury rates, we also support the provision permitting states to override the federal preemption, as it represents an equitable balancing of federal and state interests. We expect, however, that few states will exercise this provision, as they recognize the harmful effects of usury ceilings in integrated credit markets.

Title VIII - Demand Deposit Deregulation

Title VIII repeals the prohibition on the payment of interest on demand deposits by member banks, insured nonmember banks, and federal thrift institutions. The DIDC would be required to set maximum rates of interest on demand deposits equal to the rate established for NOW accounts.

As stated in previous testimony, we support demand deposit deregulation, but only as part of a comprehensive financial reform package. The removal of the prohibition against interest on demand deposits is the logical final step in eliminating interest rate ceilings, provided it is done in conjunction with the removal of product and geographic barriers. S. 2181 does remove many such barriers, and therefore, we support the removal of interest rate restrictions on demand deposits in this context.

The payment of interest on demand deposits would benefit all savers, and particularly small businesses. Unlike individuals who may hold NOW accounts, and large businesses which employ sophisticated cash management services, small firms generally may not be compensated on their transaction accounts. Title VIII would eliminate this inequity by enabling all depositors to earn interest on demand deposits.

Title VIII would also remove the inequity between depository institutions and money market mutual funds in the competition for corporate accounts. The deregulation of interest on demand deposits would allow depository institutions to offer the same interest-bearing demand deposits to corporations that are presently being offered by money market mutual funds.

We also support Title VIII, rather than some other bills on the same topic, because it does not expand the current authority of thrifts to accept demand deposits. It would be a mistake to grant thrift institutions the authority to accept demand deposits until the differences in the legal framework governing commercial banks and thrifts are removed. The disparities in capital requirements, tax treatment, geographic restrictions and the ability to offer new products should be eliminated before thrifts are permitted to offer demand accounts to all categories of customers.

Title IX - Fraudulent Use of Credit Cards and Debit Cards

Title IX of the bill expands and strengthens the current fraud provisons of the Truth-in-Lending Act and the Electronic Fund Transfer Act. Among other things, Title IX would define "credit card fraud" to include the misuse of account numbers. It would also increase the criminal penalties for second and subsequent convictions.

We strongly support Title IX as a means to stop the increase in credit card fraud. It is estimated that credit card fraud now exceeds $1 billion annually. Eventually, this cost is passed on to all consumers. The existing statutes are not sufficient to deal with all forms of credit card fraud.

For instance, the courts have held that the present Truth-in-Lending Act does not apply to the fraudulent use of a credit card number. See U.S. v. Callihan, 666 F.2d 422 (9th Cir. 1982). Title IX would close this loophole, by providing criminal penalties for the misuse of actual or fictitious account numbers.

As a technical amendment, we suggest that the reference to "section 916" in section 901 be amended to read "section 916(b) of the Electronic Fund Transfer Act", and that the reference to "section 134" in section 902 be amended to read "section 134(a) of the Truth-in-Lending Act". As the bill is currently written, these references are confusing.

Title X - Interstate Banking

This title would authorize states to adopt interstate banking and branching standards subject to reciprocity or regional or other geographical limitations. The interstate authorizations would be temporary, expiring after five years, unless the required Presidential report to Congress would recommend otherwise.

In the past, we have consistently supported geographic deregulation of banking. Such deregulation, coupled with relaxed product powers, will significantly enhance competition in the financial marketplace. The direct benefits of increased competition among financial services institutions will be a wider range of consumer choice and a climate conducive to industry innovation.

In addition to Title X, several other bills have been introduced which also propose geographic deregulation:

- Title X is an expanded version of Sen. Tsongas' "New England Interstate Banking Act of 1983" (S. 1002) which would authorize regional or reciprocal arrangements by the New England states only.
- Sen. Mattingly's "Interstate Banking Act of 1983" (S. 2113) is also an expanded version of S. 1002. It would permanently permit any state to authorize interstate banking. Although the bill in its operational provisions does not explictly refer to reciprocity or regional conditions, it recognizes, in general terms, that legislation including a reciprocal or regional limitation would be considered to be enacted pursuant to the power of Congress to promote interstate commerce.
- Sen. D'Amato's "Banking Geographic Deregulation Act of 1983" (S. 2107) would repeal the Douglas Amendment after five years. During the five-year phase-in period, it would allow bank holding companies to establish or acquire, each year, one bank in two states. This bill would affect bank holding companies only.

While we would prefer more extensive geographic deregulation, we also welcome any -- even partial -- relaxation of the current restrictions. For instance, authorizing reciprocal or regional expansion may be a reasonable first step in the direction of nationwide interstate banking.

Title X amends the current Bank Merger Act to authorize interstate mergers of banks to involve a bank from another state if such mergers are explicitly authorized by the statute of the other state. However, Title X fails -- by apparent oversight -- to amend 12 U.S.C. 214-214c, which authorize the conversion, merger or consolidation of national banks with state banks, and sections 215-215b, which authorize the consolidation or merger of national or state banks into national banks. These sections currently confine conversions, mergers or consolidations to the state in which the national bank is located. To achieve the intended purpose of Title X (and to create parity with the expanded merger authority of bank holding companies and thrift institutions), a specific amendment of these provisions is necessary. Again, we would be happy to provide drafting assistance in this respect.

THE INSURANCE DISTRIBUTION SYSTEM AND BANKS

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THE INSURANCE DISTRIBUTION SYSTEM AND BANKS

INTRODUCTION

This paper discusses advantages to independent insurance agents and national and state banks in establishing relationships to enhance the marketing of property-casualty and life insurance products to individual and commercial customers. It was commissioned from Hales and Associates by the Office of the Comptroller of the Currency to advise the agency about the possibility of such relationships. It may also serve to define some issues and focus the thinking of individuals and groups involved in insurance and banking as they consider their positions on legislative and regulatory proposals. Hales and Associates has provided management consulting services to members of the independent insurance agency system for more than 12 years.

First we will provide some basic background information to set the stage for more in-depth discussion of:

- Trends in the distribution of market share;
- Insurance company relations with their agents;
- Independent agents' strengths and weaknesses and strategic options;
- Possible joint ventures and affiliations of banks and independent agents.

BACKGROUND

The insurance business, generally thought of as one huge industry, is actually comprised of two major segments, property-casualty and life and health. Approximately 4,900 insurance companies operate in the United States; some 2,953 offer property-casualty coverage, 1,984 offer life insurance, and more than 1,000 underwrite health insurance. Many companies, primarily the industry giants, offer all three lines of coverage.

Within the property-casualty segment, about 900 companies, or 30 percent of the universe, account for most of the business written. According to A.M. Best Co., the 23 largest of these companies accounted for over 57 percent of total property-casualty premiums written in 1982 and, within the life insurance segment, the top 100 companies, or 5 percent of the total number, currently account for more than 68 percent of new business issued.

In addition to business underwritten through these traditional risk-bearing sources, corporate risk retention accounts for more than 26 percent of the real U.S. commercial insurance marketplace. That is equivalent to about $18 billion in premiums out of the $69 billion commercial market, according to a study recently completed by Conning & Co., a Hartford, Connecticut financial analysis and consulting company. This self-insurance portion of the property-casualty industry is broken down into about $12 billion in self-insured premium equivalents and $6 billion in premiums placed with "captive" insurance companies formed by commercial and industrial corporations primarily to insure their own risks. These captives are domiciled in places with favorable regulatory and tax treatment such as Bermuda, as well as Colorado, Vermont, and Tennessee.

The total premium volume of the property-casualty segment in 1982 was about $123 billion; $69 billion, or 56.1 percent, was categorized as commercial lines and $54 billion, or 43.9 percent, was personal lines. During the same year, premium income from the life and health segment exceeded $105 billion, making insurance a $228 billion industry.

DISTRIBUTION

A key question to the purpose of this paper is how does all of this money flow from the consumer, both personal and commercial, to the more than 4,900 insurance companies and financial institutions?

Before answering that question, it will be instructive to point out that property-casualty and the health and life portion of employer-sponsored group insurance plans are generally bought rather than sold. Life insurance, the only insurance that is really optional to the consumer, generally is sold rather than bought. Thus, producers of property-casualty and group insurance sell themselves and their organizations to the consumer on the basis of price and service rather than insurance per se while life insurance producers first sell the need for the product and then sell price and service. Thus it is that the property-casualty industry has more of a service and price orientation while life insurance people must be better salespersons.

Life and health insurance is dominated by the larger mutual companies which sell through thousands of full-time agents who generally have exclusive contracts with one company. Those mutuals, however, also encourage business from non-exclusive brokers. The major stock life insurance companies likewise have networks of full-time agents, but they depend more on brokered business, especially from agents who deal with their property-casualty subsidiaries and affiliates. Smaller life insurance companies tend to rely on brokered business rather than having full-time producer organizations.

Insurance companies distribute their products in several ways. They may solicit the consumer directly, through captive agents, or they may rely on the independent agency system, and/or those who accept business through brokers.

Agents vs. Brokers

At this point, the distinction between agents and brokers needs to be made. An agent acts for and on behalf of the insurance company. Whether or not the agent may represent more than one company depends on terms of the agency agreement. A broker acts on behalf of the buyer and usually does business through an agent, although some companies have direct brokerage agreements.

In most states, most agents are also brokers and vice versa, especially on the property-casualty side. Some jurisdictions, however, limit the ways insurance may be marketed. For example, Wisconsin requires producers to act as agents for their contract companies only -- there is no such thing as a broker. In Manhattan and San Francisco, on the other hand, as a matter of custom producers act as brokers and not agents.

An aspect of the agency-broker distinction important to this paper is that a broker does not undertake any credit risk. An agent, by contrast, is responsible for collecting premiums from insureds and brokers. As a consequence, the insurance agency earns a significant portion of its income by collecting and investing premiums before payment is due to the insurance company. An increase in the practice of an insurance company billing the insured directly has reduced agency income.

Captive Agency Companies

The major "captive" agency companies such as State Farm, Allstate, Nationwide, and Farmers do not allow their agents to contract with other companies or to be licensed as brokers. All of the business those producers write must go to the company they represent. Thus the term "captive" agency. That system has increased its market share dramatically and consistently over the past years.

Direct Writers

The "direct writers" sell insurance direct to the consumer without the use of agents or brokers. These companies, active primarily in the life and health field, rely on direct mail, telephone solicitation, and newspaper advertising with coupon response. In the property-casualty segment of the industry, such better known companies as GEICO (Government Employees Insurance Company) and Colonial Penn market personal lines insurance direct and to members of affinity groups.

Independent Agency System

The independent agency system includes approximately 69,500 business entities that distribute property-casualty insurance products. These agencies have the option to represent and sell insurance for more than one company and have legal ownership of renewal rights. As a consequence, independent agencies control placement of insurance on behalf of the insured.

In 1982, independent agencies produced approximately $65 billion, or 52.8 percent of the $123 billion total property-casualty premiums. From that, they grossed roughly $10 billion in direct commissions. The agencies gained another $1 billion in income from investment of collected premiums and various incentive commissions based on premium growth and lower than average loss experience. Commissions generated from the sale of life and health insurance add an estimated $1 billion. Thus, in 1982, independent agencies total gross revenues approximated $12 billion.

National Brokers

The independent agency system includes 10 firms that are referred to as national brokers. Five are publicly owned. Two are owned by insurance companies and the remaining three are controlled by their employees. All of these national brokers conduct business internationally and some have diversified into related financial services. It is difficult to segregate income between domestic, international, and diversification; however, their total reported gross revenues in 1982 were $2.9 billion, or 24 percent of the independent agency system.

For national brokers, most of their business is conducted with agency companies for whom they also act as agents. They are wearing two hats--that of the companies which they represent and that of the insureds for whom they supply services.

1982 Revenues of National Brokers
($ in Millions)

Name	1982 Revenues	Ownership
Marsh & McLennan	$ 924.3	Public
Alexander & Alexander	573.3	Public
Frank B. Hall	364.9	Public
Johnson & Higgins	323.7	Private
Fred S. James	241.3	Insurance Co. (Transamerica)
Corroon & Black	172.1	Public
Rollins Burdick Hunter	118.4	Insurance Co. (Combined)
Bayly Martin & Fay	84.8	Private
E. H. Crump	49.3	Public/Ins. Co. (Reliance)
Arthur J. Gallagher	48.5	Private (going public)
	$2,900.6	

Next 10 Independent Agencies

The remaining 10 of the 20 largest independent agencies in the U.S. include two domestic publicly owned brokers, the U.S. portion of a Canadian-controlled international broker (public), two foreign-owned or controlled brokers, four privately held firms, and one agency owned by a bank. Together, these 10 firms grossed $240.2 million in revenues during 1982.

1982 Revenues of Next 10 Independent Agencies
($ in Millions)

Name	1982 Revenue	Ownership
Reed Stenhouse (U.S. only)	$44.7	Foreign/Public
Jardine Ins. Brokers	34.1	Foreign/Public
Emett & Chandler	29.9	Public
Poe & Associates	25.8	Public
Republic Hogg Robinson	25.1	Foreign/Industrial
Financial Guardian	22.3	Private
Hilb Rogal & Hamilton	17.6	Private
John L. Wortham	14.5	Private
Lawton Byrne & Bruner	13.5	Private
First System Agency	12.7	Bank
	$240.2	

All but the four smallest of the 20 largest firms achieved their positions by aggressive programs of merger and acquisition, mostly during the 10 years from 1969 to 1979. That drive to merge has waned as they have attained the geographic spread they sought. Also, recent declines in earnings have depressed the values of broker stocks and high interest rates have mitigated against cash purchases. Acquisitions of smaller firms, therefore, have become less attractive. Thus, a lessened demand together with lower values has reduced the previously active market for smaller agents and brokers.

Remainder of Independent Agency System

The next 80 agents and brokers, completing the top 100, realized a total of $442.4 million in 1982 revenues from all sources (The Hales Report, July 1983 issue).The smallest of those, number 100, realized $3.1 million in revenues.

Thus, the top 100 firms account for $3.58 billion, or 30 percent of independent agencies' gross income. The remaining 69,400 firms in the independent system generate approximately 70 percent of the revenues.

MAJOR TRENDS IN THE DISTRIBUTION OF MARKET SHARE

As we discussed, total 1982 revenues of the system includes commissions from the sale and service of property-casualty products, fees for risk management services, commissions from the sale of life insurance and health insurance products, contingent commissions based on the profitability of property-casualty products placed with contract carriers, and investment income earned on the agency's own funds and interest on premiums held in transmission between the insured and insuror.

For the independent agent, commission rates vary with insurance company and the volume and type of business as well as the service provided. On very large accounts commissions are frequently negotiated. In the direct writer and captive agency systems, employees are usually compensated by a base salary with some volume incentives. Where compensation is on the basis of commission, the rate of commisssion is lower than that earned by independent agencies because the companies provide most of the servicing and bill the insured directly. Therefore, an analysis of relative market share on the basis of gross income to the producer would be inaccurate.

Instead, we will look at the distribution of premium volume. First we will compare the independent agency companies with the direct writers, including captive agency companies, and then we will attempt to segregate the national brokers from the rest of the independent agency system. After considering self-funded premium equivalents, we will factor in market share data.

Market share (excluding self-insured premium equivalents) of the independent agency companies over the last 5 years for all lines of insurance written in national agency as well as regional insurance companies is compared with that for direct writers, including captive agency companies, in the next table.

The independent agency system is losing almost 1 percent of the total commercial and personal lines market each year to the direct writing and captive agency companies.

Market Share of Premium Volume*
(Excluding Self-Insured Premium Equivalents)

	Independent Agencies		Direct/Captive Companies	
Year	Share	Rate of Decline	Share	Rate of Increase
1978	64.2%	(.3%)	35.8%	+.6%
1979	63.4	(1.2%)	36.6	+2.2%
1980	63.0	(.6%)	37.0	+1.1%
1981	62.3	(1.1%)	37.7	+1.9%
1982	61.4	(1.4%)	38.6	+2.4%
5-year Change		(4.7%)		+8.3%

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*Basic data derived from Best's Review, July 1983.

Independent Agency System Share of Market, by Type of Insurance, 1978-1982

	1978	1979	1980	1981	1982	Change 1978/ 1982
Pvt Passenger Auto	41.9%	39.9%	39.2%	39.0%	39.0%	(6.9%)
Homeowners	59.3	57.1	55.7	54.9	54.3	(8.4)
Commercial Auto	78.4	77.9	79.1	80.7	81.0	+3.3
Commercial SMP	91.2	90.7	88.6	88.3	87.6	(3.9)
Workers Compensation	74.8	75.9	77.0	78.0	78.7	+5.2

*Best's Review, July 1983

The independent system, although steadily losing its share of personal lines and commercial packages, is holding its own and even growing in the fields of commercial auto and workers compensation.

The 20 leading insurors in the U.S., both independent and captive agency companies, wrote almost $57 billion in premiums during 1982. That constitutes 54.2 percent of the $105 billion market before considering self-insurance, and 46.3 percent after adding $18 billion in self-insurance premium equivalents.

20 Largest Insurors' Market Share of Premiums Written
($ in Millions)

Rank	Company	1982 Premiums	Percent Change 1981 to 1982	Market Share Captive/Direct 1982	Market Share Captive/Direct 1981	Market Share Independents 1982	Market Share Independents 1981
1	State Farm	$ 9,375.5	9.8%	8.9%	8.5%	-	-
2	Allstate	5,892.7	9.2	5.6	5.3	-	-
3	CIGNA	3,766.9	(3.5)	-	-	3.6%	3.9%
4	Aetna L&C	3,718.8	(8.1)	-	-	3.5	4.0
5	Travelers	3,184.7	6.0	-	-	3.0	3.0
6	Farmers	2,936.8	10.0	2.8	2.6	-	-
7	The Hartford	2,835.1	(0.9)	-	-	2.7	2.8
8	Continental	2,771.0	1.3	-	-	2.6	2.7
9	Liberty Mutual	2,674.3	(0.4)	2.5	2.7	-	-
10	Fireman's Fund	2,599.5	3.7	-	-	2.5	2.5
11	AIG	2,493.2	3.8	-	-	2.4	2.4
12	Nationwide	2,004.7	4.7	1.9	1.9	-	-
13	USF&G	1,876.3	(2.9)	-	-	1.8	1.9
14	Crum & Forster	1,839.7	3.2	-	-	1.8	1.8
15	St. Paul	1,625.7	3.5	-	-	1.5	1.6
16	CNA	1,556.9	(3.3)	-	-	1.5	1.6
17	Commercial Union	1,523.2	5.6	-	-	1.5	1.4
18	Home	1,523.2	(4.9)	-	-	1.5	1.6
19	Kemper	1,386.5	(3.1)	-	-	1.3	1.4
20	Royal	1,352.3	9.9	-	-	1.3	1.2
		$56,934.0					

Except for Liberty Mutual, all of the captive agency companies maintained or increased their market share between 1981 and 1982, led by State Farm and Allstate. Among the independents, only Commercial Union and Royal Globe, both owned by British holding companies, experienced any increase in share of the U.S. market. All of the other independents either lost market share or stayed even. Thus, we see that the very aggressive marketing efforts of State Farm and Allstate in particular have resulted in their continued growth in the personal lines marketplace at the expense of the independent agency system.

State Farm, with 8.9 percent of the total insured market, is the leading writer of all forms of premium in 30 states, ranks second in nine states and third in three states. Allstate ranks first in only two states but is second in six states and third in 13 states.

CIGNA, leads the independent companies with 3.6 percent of the market. That company ranks first in one state, second in one state and third in three states while Aetna Life & Casualty ranks first in two states, second in two, and third in five states.

Independent agency companies' share of all lines except specialty lines has decreased significantly since 1978. In Alabama, Arizona, Arkansas, California, Colorado, Florida, Maryland, Missouri, Nevada, New Jersey, Utah, Virginia, Washington and West Virginia, they held less than 60 percent of the market. By contrast, they have maintained or increased market share to more than 70 percent of premiums in Alaska, the District of Columbia, Hawaii, Iowa, Massachusetts, New Hampshire, South Dakota, and Vermont. The only other states that experienced an increase in independent agency company market share were Montana, New Mexico, North Dakota, and South Carolina.

It is interesting to note that the only populous state where the independent system experienced relative growth was Massachusetts, where state mandated rates on compulsory auto insurance have cost direct writers their price advantage. The other growth states for independent agency companies are all small in size or population or both. Presumably the captive and direct systems are focusing first on the growth areas.

To summarize this section on market share, it will be instructive to take the analysis one step further by adding self-insurance premium equivalents to the total market and then separating out the independent agent portion of the revised total market between the nine national brokers and the rest of the independent system. Because we do not have historical data for all years, we will estimate 1978 market share and will predict 1988 market share.

Estimated Comparative Market Share, 1978, 1982, and 1988
($ in Millions)

	Estimated 1978	1982	Compound Growth 1978-82	Projected 1988	Compound Growth 1982-88
Underwritten Premiums	$81,700	$105,000	6.5	$133,980	5.0
Self-Funded Premiums	9,941	15,120	11.1	28,700	13.7
Total Premiums	$91,641	$120,120	7.0	$162,680	6.3
Independent Agents					
Premium Volume	$39,375	$ 47,145	4.6	$ 57,210	4.9
Share of Total	43.0%	39.2%	(2.5)	35.2%	(2.5)
National Brokers					
Premium Volume	$13,076	$ 17,325	7.3	$ 21,436	5.6
Share of Total	14.3%	14.4%	0.1	13.2%	(1.75)
Self-Funded					
Premium Volume	$ 9,941	$ 15,120	16.0	$ 28,700	13.7
Share of Total	10.8%	12.6%	4.0	17.6%	6.9
Direct/Captive					
Premium Volume	$29,249	$ 40,530	8.5	$ 55,334	6.4
Share of Total	32.0%	33.7%	1.3	34.0%	0.2

Estimates of self-funded premiums are by Conning & Co. They may include some redundancy of premiums that may be more appropriately credited to independent agency companies. Independent agents are frequently retained by self-funding companies and their captives to plan and administer their programs. Consequently, while premium equivalents are shown outside of the independent system, agents and brokers in that system do derive fee income from the self-funded segment of the industry. Also, some independent agents and brokers place business they control with companies categorized as direct and captive agency companies, notably Liberty Mutual, Employers of Wausau, and Northbrook, a subsidiary of Allstate. Those premiums are counted as being outside of the independent system even though independents derive fee income from their insureds.

The statistics, although imperfect, do serve to indicate several trends. Clearly, the traditional independent agency system has lost market share to a combination of national brokers, self-funded accounts, direct writers, and captive agency companies. We expect that loss to continue at both the lower end (personal lines) and the higher end (complex commercial accounts) of the market.

The national brokers' growth, measured by premium volume, has slowed and also is expected to decline, although their fee income from risk management services is likely to grow.

Direct writers and captive agency companies will continue to increase their share of the market, especially in personal lines. State Farm and Allstate will lead, with Farmers and Nationwide not far behind. In addition, some national agency companies, such as The Hartford, are experimenting with direct solicitation of personal lines while trying to maintain traditional agency relationships.

The primary market forces changing this distribution are:

1. Price - Insurance is becoming regarded as a commodity, especially in the commercial lines.

2. Competitive (soft) market - Intense competition has affected all agents and brokers except for those almost exclusively in the personal lines market. Large, national brokers and the larger local and regional agencies handling the bigger corporate accounts have been especially hard hit.
3. Efficiency - Direct writers and captive agency companies have controlled distribution and are well automated. This efficiency gives them a cost advantage over the independent system which allows lower premiums.

4. Marketing skills - State Farm and Allstate both have very effective national advertising which allows them to capitalize on controlled distribution. The independent agency system has not demonstrated an ability to produce the same quality of advertising nor can it match the advertising budgets of the direct and captive systems.

5. Self-funding - During the "tight" markets of the mid-1970's, large corporations learned how to self-fund and manage their own risk programs. These disciplines remained when capacity returned to the marketplace but the market did not return to capacity. Corporate risk managers found out they could do without the broker for major portions of their risk retention programs. Thus, this sector has seen fast growth in premium equivalents.

6. Buyer sophistication - Insurance buyers today know more about insurance than ever before. They no longer accept carte blanche what their agent or broker tells them. This has increased buying from direct writers (GEICO-Colonial Penn) and from captive agency companies (State Farm-Allstate). The emergence of the personal computer, home marketing, telecommunications and credit cards and the entry of banks and other financial institutions into the insurance market will further increase insurance buying choices.

INSURANCE COMPANY RELATIONSHIPS WITH AGENTS

The competitive market has had a devastating effect on the national agency companies which write the bulk of the premium volume. Had it not been for high interest rates followed by a buoyant stock market, the race to use expanded surplus accumulated during the tight market environment of the mid-1970's and to maintain and expand market share would have broken many a company.

Insurance company reaction has not been to increase prices but rather to cut costs. Significant payroll purging has taken place in most if not all of the leading property-casualty insurors -- people are being replaced by computers.

As companies reduce their headcounts, so do they strive to reduce the number of agents representing them. They recognize that a high percent of the business comes from a small percent of the agents. Thus, CNA has created a "super" group of agents called "HPA" or high performance agents who will commit a significant volume of their business to CNA in exchange for commitments from CNA for higher contract commissions and other benefits. Commercial Union, one of the few national agency companies to increase its market share in 1982, provides many special benefits to its "Independence" agents. Continental has its "Circle Agents," Kemper its "Partnership" agents, Fireman's Fund its "MVP" or most valuable producer group, and so on.

CIGNA, the leading independent agency company in market share, has two groups of special relationships. In addition to its "Partnership" group, many agencies have joined the One-Compar category. They agree to represent only CIGNA and receive a generous one-time "roll over" fee on business transferred from others to CIGNA, higher basic commissions, a generous profit-sharing agreement, and competitive pricing. It would seem that CIGNA's strategy here is to build a "State Farm-like" system within the independent agency system.

Most of the larger companies offer their better performing agents a smorgasbord of benefits. Those benefits include bonus commissions for growth (most of which comes from business consolidated from other companies), additional pay for agency underwriting programs, training programs, cooperative advertising, aid to finance purchases of other agencies as well as automation systems, salaries for new producers, and funds for internal ownership perpetuation programs.

The agency system, never well capitalized, has been very hard hit by the soft market as declining premiums on existing accounts result in lower commissions and deprive agencies of income contingent on profitablity. Depending on the competitive nature of their geographic locations, agencies must thus generate 10, 20, or even 30 percent in new business each year just to stay even. Since independent agencies have traditionally been more service than sales oriented, new business has been hard to come by. As expenses rise, profit margins suffer. Thus, losses that occur can only be financed from already weak capital positions. Thus, national agency companies seek to identify those agencies who they believe to have the internal capacity to survive, and back them with enhanced agency agreements and marketing assistance.

What happens to the less productive agents? The top 1,000 agencies represent less than 2 percent of the players in this game, but account for just over 42 percent of combined gross revenues.

All of the other agencies account for 48 percent of the system's total revenues and average just under $120,000 in revenues from production of approximately $750,000 in property-casualty premiums. Since most of these firms split their premium volume between 5 to 10 companies and have a lead carrier which gets about one-third of their volume, they represent an expensive part of the national agency companies' distribution network. Were it not for the fact that most of the smaller agencies are located in rural markets where loss ratios are significantly lower, major companies would not hesitate to terminate such relationships. Nevertheless, those agencies can expect a lower commission on the same premium dollar in the future. Thus, a two-tiered commission structure seems to be evolving that may reward the larger, growth-oriented agencies at the expense of the smaller ones.

To combat this, smaller agencies will gravitate to the lesser lights in the underwriting world, sell out, or merge with each other and with larger agencies.

Ownership of Renewals

The independent agent is a unique business entity in that its list of customers is a distinct property right and which has a value that is separate and distinct from goodwill. Thus, renewals (expirations) are readily marketable and are a property much in demand by larger firms.

A buyer of renewals has a distinct marketing edge over competition because the buyer gains knowledge not only of the policyholder's expiration date (the time when a purchase decision is made), but also of the coverage to be renewed, the price at which it was previously written, and the company in which it was written. In addition, the buyer has the entire policyholder's file.

To offset the impact of the soft market, many agencies are interested in acquiring ownership of renewals from a third party. That puts business on their books much faster than it can be generated through internal sources. Therefore, the demand for smaller agencies is perhaps as high as it has ever been, forcing prices that must be paid to acquire the smaller firms upwards from the traditional benchmark of 1 1/2 times commissions to 2 and 2-1/2 times. In fact, we have seen prices paid in excess of 4 times commissions.

Although small agencies do not have intrinsic value any where near those levels, most larger firms can afford to pay such prices because the profit margins on acquired books of business can be quite high if the owner/producer does not go with the business and the accounts can be handled by the buyer with little or no increase in staff or rental expense (the two highest costs of doing an agency business).

Insurance companies are anxious to help their leading agents finance such purchases because they usually strengthen the buyer, they protect the business the company has with the smaller firm and adds it to a larger base, and they benefit the insurance company when other business is "rolled over" from incumbent carriers.

Insurance Company Strategies Toward Controlled Distribution

Most major property-casualty insurance companies would do away with their entire agency force if they could figure out how to do business direct and how to bridge the gap between starting such a process and when they can make up for the premium volume lost as agents move business elsewhere in retaliation.

A number of major companies currently own all or part of independent agents. For many years, Travelers has owned and operated a group of agencies under the style "Plaza Corporation." At first agents were uncomfortable with this endeavor, but it is relatively small (about $6 million in total revenues from a dozen or so agencies) and Travelers has made no concerted attempt to add to it. More recently, Aetna Life & Casualty purchased four independent agents, one large and semi-national, totalling close to $15 million in revenues. Agent reaction has been adverse and emotional. Both Travelers and Aetna have benefitted from owning these firms because they have learned, first hand, about how independent agents do business. These positions do not appear to be part of an effort by Aetna and Travelers to acquire their own distribution systems.

Reliance Insurance Company acquired 46 percent of E. H. Crump, one of the nine largest independent agency firms. What Reliance does next will likely depend on whether there are other insurance company/agency combinations elsewhere in the industry.

The Hartford, a subsidiary of ITT, seems to have a multi-faceted strategy. It owns 50 percent of a large energy-oriented agency based in El Paso, Texas, the $12 million-revenue Desert American. The other 50 percent of that firm is owned by Burlington Northern. The Hartford also owns 40 percent of a venture called ADAPT, the other 60 percent of which is owned by a group of 15 independent agents. ADAPT has acquired six agencies in California and Texas with total revenues of almost $4 million. The Hartford's stated purpose in taking these positions was to obtain a "window" on the agency system, and to generate more premium volume. However, The Hartford also has taken over the American Association of Retired People and plans to solicit this huge, $3 billion premium market direct.

Two insurance copmanies have acquired national brokers. In 1982, Transamerica acquired Fred S. James, the fourth largest U.S. broker, and in 1983 Combined International acquired Rollins Burdick Hunter. That made Combined, which had already acquired James S. Kemper Agencies, the sixth largest U.S. broker. Neither of those companies experienced much backlash from independent agents. Transamerica, then a relatively small property-casualty underwriter, was known for doing business with smaller agents handling personal lines and small commercial accounts, and James is a large corporate account-oriented broker. Combined never really has competed with independent agents.

No discussion of insurance company strategies can be complete without a discussion of automated systems. The insurance industry is becoming electronically linked. The 20 largest companies and many smaller ones have developed extensive automated systems to deal with their internal processing of policies, underwriting standards, rating, and recordkeeping. Some systems were built to allow agents to"interface" with the company's computers in order to reduce paper flow and the redundancy of functions that has been so expensive for the independent system.

Several companies have purchased vendors of agency automated systems. Fireman's Fund purchased ARC, The Hartford bought Redshaw, Commercial Union acquired AMS, Aetna bought a system for smaller agents from McCracken, Travelers owns EBS, and Continental owns 50 percent of Insurnet. Safeco developed its own system, Safecom, and sold participations to a group of companies including Reliance and Westfield. The Hartford, in turn, sold equity interests in Redshaw to a group of companies including St. Paul and Crum & Forster, and Commercial Union sold interests in AMS to a group of five companies including CNA, Crum & Forster, Great American, AIG, and Zurich. AMS bought ARC from Fireman's Fund which retains a one-seventh interest in the consortium.

A key strategy in those companies joining together to own computer system vendors is to market the systems to agents so they can process their business electronically with that group of companies and, ideally, achieve economies which may lower premiums to the consumer. That could help make the national agency companies more competitive with State Farm, Allstate, and similar firms.

Companies that are not joining consortiums are attempting to establish direct relationships with agents that are unique and not available to others. That could give those companies a competitive advantage and tie the agencies closer to them, creating something like a controlled marketing system.

IBM has created a communications network called IVANS (Insurance Value Added System) which may eventually allow any agent with an in-house computer to access any automated company. Although the technology exists to accomplish that goal, the vastly different operating systems do not currently make this an effective vehicle for routine communications.

STRATEGIC OPTIONS

We have already discussed the independent agents and the threats they face. We would now like to focus on how they can interact with banks so that both benefit.

Perhaps the greatest strength of the independent agency system is in the quality of the people who make it up. Independent agents are entrepreneurial, intelligent, by and large highly professional, and caring. Very service-oriented, they work hard to protect their clients' assets. It is those qualities that lead customers to develop strong relationships with their agents and brokers.

The intense price competition going on since mid-1979 has caused many consumers, both personal and commercial, to place price before loyalty to past services and relationships, especially in the urban centers. Since intense price competition occurred during a national recession that affected most of the insurance buying public, budget constraints forced buyers to shop around more often than before.

Thus, while relationships have been and remain a key factor in the buyer/broker interplay, the independent agent has had to focus his attention more on price than on service. Independents will probably lose more business unless the companies they represent can meet competition from other agents and brokers, direct writers, and self-insurance. The independent agency system as a whole is gradually losing the battle for market share. At the same time, business retained has been renewed at a considerable reduction in premiums. That has lowered commission income while expenses mount and profit margins erode.

The independent agency needs to offset attrition in accounts and commission income. However, it is well-recognized that the typical property-casualty agency is more services-than sales-oriented. The vast majority of agencies rely on the three R's -- relatives, referrals, and renewals. To say that their greatest weakness is the lack of an aggressive sales effort would be an understatement.

The same is not true of the life insurance segment which is populated by very strong salespeople who first must convince the buyer of the need before a sale can be made. Once a life or health insurance sale is closed, however, very little service is required. That is why first-year commissions paid to life sales personnel are high and those paid on renewals is low. If a way could be found to marry the sales power of the life insurance industry with the service talents of the independent property-casualty agency system, both would benefit. This is where a joint marketing effort between banks and independent agents could benefit both parties.

A basic and fundamental business principle is that it is effective marketing to do more diverse business with an existing customer base. That is why banks want an entry into the insurance business--to have an opportunity to sell other financial services to households and businesses already on the their books as depositors, borrowers, or trust accounts. By the same token, insurance agents have strong relationships with their existing customer base and are in a position to influence change in banker affiliation. Therefore, banks represent a powerful marketing resource to insurance agents seeking new business opportunities.

As briefly mentioned earlier, independent agents generally lack adequate capital. Although national brokers have very strong balance sheets and historical profit margins upwards of 20 percent, privately owned independent agents have not retained earnings in their businesses and do not achieve as high profit margins. It is not uncommon to see substantial negative net worth in agencies that have grown through acquisition and/or when they have embarked on programs of internal ownership perpetuation. Those negative tangible net worth positions invariably are accompanied by negative working capital. Many agencies thus finance their operations with premium dollars they hold in transmission to their companies. Typically agencies overcome their lack of capital by seeking financing, bonus commissions, and extended payment terms from their leading companies. Some companies respond to protect their premium volume and to increase penetration of the agencies. Some do not. Few will make working capital loans unless the agency is extremely important to the company.

Again, a relationship with a local commercial bank whose business it is to supply capital to worthy borrowers is an alternative strategy for the independent agent. It may be better for capital to be supplied to independent agents by banks than by insurance companies whose incursion into agency affairs could very well ultimately limit the agency's independence and choice of carriers.

Another weakness of independent agents is their lack of business acumen. Only recently have they recognized the need to be good businessmen. Strategic business planning is a new discipline which the independent agents desperately need to develop, particularly in a time of such dramatic changes. A strategic option available to them is to work with their local bank in the planning process. This could develop into a mutual desire for a closer relationship that, if legally permissible, could include joint marketing, improved financing, and access to each other's customer base. Eventually, it could also lead to acquisition of the agency by the bank.

This leads to a brief discussion of a final weakness in the independent agency system. Whereas there are many buyers for the smaller agency that wants or needs to sell out, agencies with more than $1 million in revenues, and especially those with revenues in excess of $2.5 million, do not have the same marketability they did when the national brokers were building their networks. Consequently, the law of supply and demand has actually reduced values for many of the larger independent agencies who find it difficult or impossible to perpetuate their ownership internally.

Some insurance companies have bought out or bought into an increasing number of agencies. That process has been viewed with much alarm by agents, trade associations, and others who believe that the underwriting and the distribution functions should remain independent while maintaining their interdependence.

Thus, yet another strategic option for the larger independent agency is to regard the banking system, with its strong marketing potential, financial resources, and business acumen, as a viable alternative to insurance companies and even existing brokers as potential buyers.

INDEPENDENT AGENT/BANK AFFILIATIONS

The range of possibilities for independent agents to establish business relationships with banks is already extensive and would become even more so were Congress to open the door for all banks to distribute property-casualty and life products.

First, we will discuss possible relationships in jurisdictions where banks may legally sell insurance. They are:

- Outright Purchase of Agencies
- Joint Venture
- Joint Marketing

In addition, we will discuss an alternative available even to banks not specifically enabled to act as insurance agents. That approach is a lease arrangement, often a percentage lease.

Outright Purchase of Agencies

"Grandfathered" bank holding companies, bank holding companies with less than $50 million in assets, national banks doing business in communities with populations of less than 5,000, and state banks in certain states may sell insurance of any kind. State banks and bank holding companies must comply with state licensing laws. Thus, in some states, a bank or a nonbanking subsidiary of its holding company could become licensed and/or cause selected employees to become licensed and begin selling insurance to its customer base and the community at large.

To do so, the bank needs qualified personnel and competitive insurance company representation. To get quality company representation, there must be premium volume commitments and the companies must be satisified that professional staff has been employed.

The fastest and best way to obtain such company representation is to acquire it. In a small community, the only agencies available to acquire generally are small ones. Although such agencies are vulnerable to termination or having commissions reduced because of their size and limited growth potential, access to a bank's customer base could enable them to grow, and access to a bank's capital could enable them to add necessary staff. Because of the resources the bank can offer, such agencies become potentially more valuable to their companies.

A bank making such an acquisition must recognize that, although it is the fastest way to gain access to the industry, it is also the most expensive in the short run. Acquisition of an agency doing $100,000 in commissions could cost the bank around $200,000. To obtain a pre-tax return on capital of 20 percent the agency would need to generate $40,000 in profits, or a 40 percent margin on commissions. Such a margin is difficult if the owner/producer remains as an employee after acquisition. His or her skills would be important in the first place, so the acquiror must recognize the value added aspects to evaluate returns.

Acquiring a larger agency with $1 million or more in revenues comes at a more realistic cost because of the supply/demand relationship. There are many possible buyers for small agencies but not as many for the larger ones. Also, with larger agencies, often staff remains while the owners do not, and the savings on owner compensation can well provide the necessary returns.

A million-dollar agency may be acquired for $1.25 to $1.5 million. At that time, it has a $50,000 to $100,000 profit potential. Estimated at $75,000, that is a 7.5 percent margin. Typically, another $150,000 may be saved when owners are replaced by less expensive staff. That can bring the operating profit margins up to about 22.5 percent on a pro-forma basis. That margin provides an 18 percent return on a $1.25 million capital investment.

Nonetheless, a bank may find it difficult to justify the price it must pay to acquire expirations, personnel, insurance company contracts, and goodwill from independent agents. One alternative is a joint venture.

Joint Ventures

A bank and a local independent agency may wish to consider a joint venture whereby the licensed bank furnishes space, an endorsement, and access to its customer base; and the independent agency furnishes expertise, personnel, and its insurance company markets. Such a joint venture could be owned equally by the bank and the agency and could conduct business only to serve the bank's customers. The bank would not necessarily own any of the agency's other business unless other considerations were involved.

The joint venture could be a partnership or a corporation. The only capital required would be to fund on-site personnel until their activities become self-funded, because the necessary resources to conduct business are already possessed by one or the other of the parties. The joint venture could be run as a business and, at mutually agreeable intervals, the profits could be split between the owners. The joint venture could receive additional income from contingents and interest on the float.

If either party wishes to terminate the relationship after the venture has had a chance to succeed or fail, a buy-sell agreement would dictate the terms of a dissolution. The bank might be given first right to buy out the agency's equity interest based on a pre-determined formula or appraisal value. The agreement could also provide the bank a first right of refusal to acquire the entire agency, again on some mutually agreeable basis. That would give the agency owner(s) visibility as to the longer range marketability of their firm yet allow them freedom and time to build their business to maximize its value.

In a joint venture, returns to the bank might not be as great because the ownership would be shared, but return on capital likely would be quite high because the investment would be small and high quality service would immediately be provided to bank customers.

Joint Marketing

Similarly, enabled banks could enter into relationships with independent agents whereby the bank would furnish space, an endorsement, and access to its customer base to an independent agent who would provide all of the other resources necessary to solicit and service the available customer base, while the agency retained 100 percent ownership of the business. The bank would have a licensed entity to which the agency would pay a share of the commission income earned in exchange for the introduction of business. In effect, the bank would be compensated like other producers of business that the agency employs. The agency would take 100 percent of the business and financial risk and would keep 100 percent of the financial reward after the commissions to the bank are paid. The agency would keep all income from contingents and interest on the float.

For example, suppose such an effort resulted in the generation of $500,000 in commission income over a 5-year period at the rate of $100,000 added each year and the bank was to receive 20 percent of commissions, both first year and renewal. The $20,000 received by the bank in the first year would go directly to its bottom line, while the agency would probably lose money that year. By the end of the fifth year, however, the agency should have recovered its early losses and cumulatively be in the black. Along the way, however, the bank should not have any losses and would have realized a meaningful contribution to its profits by the end of the 5-year period.

In this scenario the agency would own the expirations. The bank might have a right of first refusal to purchase the entire agency and perhaps an option to purchase the bank-generated business separately. In either event, these rights would be subject to an up-front, agreed-upon basis of valuation and terms of payment. The bank's return on capital would be unlimited, because it would have no capital invested. Assuming the agency selected is well regarded in the community, the bank would benefit from the goodwill generated by supplying its customers with the services of a high quality independent agent.

Percentage Lease

The three ways already discussed that banks and independent agents can interact are appropriate only when the bank is legally able to be actively involved and licensed in the insurance agency business.

When that is not possible, a variation of the joint marketing approach would appear to be a viable alternative. The bank could provide space in its quarters to an independent agency on a percentage lease arrangement similar to the commercial leases used in shopping malls, shopping centers and large commercial buildings. Such leases not only recognize the value of space but also reward the landlord for the business opportunity available to vendors because of traffic flow, convenience, credibility of the landlord, etc.

Thus, an insurance agency might lease 200 square feet in a bank lobby on the basis of say 15 percent of the first $100,000 in revenues the agent derives from that specific location with a fixed minimum payment of $2,000 a year ($10 per square foot) that represents an advance against the percentage. So, if an agency were to derive $25,000 in revenues from such a location in the first year, the agency would pay $2,000 for the space and an additional $1,750 at the end of the year. If the revenues grew to $100,000, the bank's revenue would be $15,000.

If the revenues were to grow further, say to $200,000, it might be appropriate to increase the percentage to 20 percent on the incremental income, thus generating $35,000. Thereafter, the agency might pay 25 percent on revenues in excess of $200,000. Thus, a $500,000 flow of income from a single bank location would generate $110,000 to the bank, costing the agent 22 percent of commissions. The bank would not share in contingent income or interest income on the float.

Such an arrangement would not be as financially rewarding as a joint marketing approach because the bank could not act as an insurance agent or broker on its own. But it does give banks the opportunity to make insurance products and services available to their qualified customers on a basis where both the bank and the independent agent may derive a reasonable profit.

As part of the contractual agreement between agent and bank, if possible under state law, provision could be made to convert the terms to joint marketing, joint venture and/or eventual acquisition.

CONFLICTS OF INTEREST/UNFAIR COMPETITION

The independent agent has long been concerned about bank entry into the insurance business because banks' influence over their customers has been regarded as unfair competition and a conflict of interest. It is certainly true that the possibility for coercion of insurance in connection with a personal or commercial loan exists. Whether or not coercion actually occurs, some borrowers may believe that their chance of obtaining a loan may be improved if they take the bank's insurance.

That concern is precisely why the current banking deregulation bill introduced in Congress by Senate Banking Committee Chairman Jake Garn contains a provision whereby any purchase of insurance linked to an extension of credit must be subject to cancellation by the buyers within 30 days without exercise of that right in any way impinging on the continuation of the credit relationship.

We would suggest a further step of requiring any buyer of insurance from a bank agency or an independent agency affiliated with a bank to sign a statement representing that the insurance was not purchased as a consequence of any credit consideration, whether or not credit has been or might be an issue. Although that would create additional paperwork at a time when the industry is trying to minimize paperwork, we believe it could be a deterrent to improper, coercive sales techniques. Loss of license should be the consequence of violation of either the 30-day cancellation requirement or the suggested disclaimer letter.

Critics of bank entry into the insurance agency business should consider the actual experience of borrowers and insurance buyers in states where major banks have long been active in the agency business. Reaction by independent agents active in those trade areas is particularly instructive.

Interviews with agents in Minnesota and Indiana, where banks have been active in the agency business for many years and are a key factor in the distribution of insurance products, produced no complaints about "tie-in" sales of insurance or coercion. The agents regard competition from bank agencies as little different from competition from anyone else, especially in commercial lines. They do regard the convenience of an insurance desk in the bank lobby as a competitive advantage, and wish they had the same advantage.

Banks compete among themselves for bank relationships such as deposits, loans, etc. In attempting to coerce an increasingly sophisticated customer to buy insurance, the bank would run the risk of losing the customer to a competitor who is not in the insurance business or who will not coerce. No bank would risk reducing its customer base just to do some additional business. As a matter of fact, in adding insurance to the financial services it offers, the bank must be very careful to select qualified people and qualified markets with competent and fair claims facilities. Otherwise, sloppy handling and poor servicing of insurance accounts could be detrimental to the bank's basic business.

Hales and Associates feels the real risk to the independent insurance system is the possiblity that banks may engage in both the underwriting and distribution of insurance products, thereby becoming direct writers. With its distribution system already in place concentrating on an existing customer base and with access to an existing computer network, a bank-owned insurance company could price its products sufficiently under any existing system and, thereby, capture a significant share of the market in its trade area. Hales and Associates, therefore, recommends that any further deregulation of banks to allow them to participate further in the insurance business should preclude banks of any size from owning or controlling insurance companies if they are allowed to market insurance.

The independent agency system has spent and is spending a considerable amount of time, effort, and money to keep banks from penetrating the insurance business any further. We believe that those energies and financial resources could be more usefully employed in seeking ways to stop the rapid market gains of State Farm, Allstate, Farmers, Nationwide, and the other captive agency companies which are the independent agency system's real enemy.

The independent agency system's major trade associations could effectively negotiate a basis upon which they would withdraw their opposition to bank entry to the property-casualty agency business so that both sides of this issue could come out winners. After all, if the banks will generate business within the system, the end result would have to be a strengthening of the system. To be sure, some individual participants in the agency system might be hurt, but those are the same firms that reject strategic business planning, that depend on the three R's for their survival, and that will not survive as independent entities whether or not banks enter their market.

Throughout this paper we have spoken of strengths and weaknesses in the system and have suggested various ways banking organizations could effectively join with independent agents so that both segments could do a better job of providing the consumer with a better product and better service to their mutual advantage.

Respectfully submitted,

David Hales, President
Hales & Associates, Inc.

HALES & ASSOCIATES, INC.

Hales & Associates, Inc. is a consulting firm specializing in services to the insurance industry, with a heavy emphasis on the agency and brokerage side of business. The largest volume of work is represented by consulting with privately owned firms to assist in finding solutions to problems of a financial nature. Advice in this area centers on general management consulting, organizational planning, perpetuation planning, compensation studies, and ESOT feasibility, as well as evaluations including an opinion with respect to fair market value. As a result of its work on numerous appraisals, the firm has become internationally acknowledged as an authority on that subject and has been called upon to provide expert witness testimony.

Closely associated with the financial consulting end of the business is the acquisition work with which Hales becomes involved as an adjunct to perpetuation planning. Although committed to helping the privately owned firm that wants to stay that way, Hales recognizes that there are times when corporate business opportunity, personal career development, and value considerations could be materially enhanced through merger with a larger firm. In such a case, Hales will represent the closely-held client in seeking the most advantageous merger partner. As part of the structuring of the transaction, the firm will also provide documentation for the valuation of insurance renewals to be used in depreciating these expirations for income tax purposes.

In the course of its financial consulting work, Hales has been asked to provide other services for its clients. Systems analysis and evaluation of automated systems is provided as a complement to the organizational and management consulting services. Emphasis is placed upon helping the client determine system requirements consistent with long range business plans. Assistance is provided for computer software and hardware evaluation, selection and implementation of systems, as well as development of the office procedures to support those systems, and corresponding job descriptions and performance evaluation systems.

An important aspect of Hales' service is the publication of The Hales Report, a monthly compilation of news concerning the financial and administrative aspects of the insurance brokerage business. The report is broken down into several sections including a summary of news with occasional editorial comment, analysis of relative operating performance posted by public insurance brokers, factual comparative stock market performance, detailed news of business combinations announced publicly, and an analytical section containing original research relating to special situations in the industry.

The report goes to over 1,400 individual subscribers from more than 800 organizations. Subscribers include all of the public brokers, over a dozen leading insurance carriers, most of the 100 largest privately held brokers, and various investment bankers, CPA firms, and consultants.

In 1983, Hales performed services for more than 125 clients. At present, the firm enjoys current and on-going relationships with many of these clients while various projects have been completed for others. Principals have appeared before 41 industry groups for speaking engagements and have participated in the preparation of the textbook for Part 3 of the Producer series introduced by the American Institute of Property & Liability Insurance. Projects have also been completed for eight firms outside the insurance industry.

The CHAIRMAN. Thank you, Mr. Conover.
Mr. Isaac.

STATEMENT OF WILLIAM M. ISAAC CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Chairman, we appreciate this opportunity to present the FDIC's views on S. 2181 and S. 2134. Our staff is preparing a more detailed comment on these bills, which will be forwarded to you promptly. We would appreciate your including that analysis in the official record.

The FDIC strongly supports the general framework for deregulation set forth in S. 2181 and its predecessor S. 1609, introduced last year at the request of the Administration. We commend you and your colleagues on the Committee for advancing the debate on the issue of deregulation of the financial-services industry.

Banks have held a very special place in our society and economy for at least the past 50 years. The American public has insisted that we maintain stability in the financial system, following the banking collapse of the 1930s. A principal means through which this has been achieved is the provision of federal insurance for deposits placed in banks. The public believes in the federal deposit insurance system and expects its government to maintain the strength and integrity of that system.

So my first premise is that we must do whatever is necessary to enable the deposit insurance system to continue protecting the public's savings deposited in banks, up to the insurance limit of $100,000.

My second premise is that the public desires a financial system that offers a broad range of services at competitive prices to the maximum extent consistent with stability and safety.

My third premise is that our deposit insurance system should not become a drain on the U.S. Treasury -- that is, it should continue to finance itself through bank assessments and interest earned on its investment portfolio.

My fourth premise is that whatever financial system evolves should be fair and equitable to both the general public and financial institutions.

With these thoughts in mind, let me offer for your consideration a definition of the term "bank" and then turn to a discussion of some of the issues presented by S. 2181 and S. 2134.

Definition of a Bank

A "bank," in our judgment, is an entity the public believes is or should be a safe-haven for its funds at least up to some specified amount. The key element, in terms of public perception, is whether an organization holds itself out to the public as a "bank" by using that term in its name. If an organization calls itself a bank, it ought to be required to be FDIC insured and regulated as a bank.* No entity may be FDIC insured unless it both accepts deposits and uses the term "bank" in its name.

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*There would be an exception to the prohibition against the use, by non-FDIC entities, of the term "bank" for government organizations or entities that do not accept the public's funds.

This definition would close the "nonbank bank" loophole. It would also subject banks and thrifts that choose to look like banks to the same regulatory treatment. Finally, it would prevent a recurrence of tragedies like those we recently witnessed in Iowa and Tennessee, where uninsured banks failed causing thousands of people to lose their savings at entities that held themselves out to the public as "banks."

Greater Competitive Freedom for Banks

We believe banks should be authorized to engage in a broader range of financial activities for two principal reasons. First, it would be procompetitive. The American public -- including consumers, small businesses and farmers -- would be given a broader range of financial products at more competitive prices. Second, it would strengthen the banking system by allowing banks to be more competitive in the financial marketplace and develop new sources of income to help offset the cost of liability deregulation.

The question, in our judgment, is how far can we go without creating an undue risk to the deposit insurance system or creating a competitive climate that would be unfair to competitors of banks?

From the viewpoint of safety, we believe it appropriate to divide financial services into two categories: those that are offered in an agency capacity and those that are offered by a bank as principal. We believe there is very little risk in a well-managed bank acting as an insurance, real estate or securities agent or broker, and we would authorize these activities to be conducted in the bank itself.

When it comes to underwriting insurance or securities or developing real estate, the risks are greater. Accordingly, we would authorize these activities only in affiliates of banks, coupled with other appropriate safeguards, such as requirements for separate capitalization and funding, different names and logos, and strict limits on interlocking management and directors. Safeguards such as these would insulate banks from the greater risks these activities entail and also promote fairness with respect to nonbank competitors.

We have testified previously that brokerage or agency activities should be permitted within the bank itself and that underwriting activities should be permitted in bank subsidiaries rather than requiring all these activities to be placed in separate holding company affiliates. We have taken that position because we believe it would provide adequate protection to the bank while permitting the bank and its customers to directly benefit from the profits and capital base generated from the new activities. Moreover, it would allow people to avoid the expense and inconvenience of forming a holding company.

While we still believe very strongly in these principles and urge Congress to enact legislation along these lines, we recognize that legislation broadening the permissible activities of banking organizations is essential. Consequently, we would not oppose legislation that requires the new activities to be conducted in a separate holding company affiliate if that is necessary to achieve a political consensus for reform.

We would encourage you to enact as broad a bill as possible with respect to permissible financial activities. For example, in the securities underwriting area, I would go further than S. 2181 and allow the underwriting of corporate securities.

The Glass-Steagall Act prohibits member banks from affiliating with investment banking firms. The law was enacted in response to the collapse of the banking system in the 1930s. We do not believe it was an appropriate response. There were abuses by securities firms during that period, but there is no evidence those abuses were more prevalent among bank-affiliated securities firms than among securities firms generally. Neither is there evidence those abuses caused significant problems in the banking system.

The banking system collapsed during the 1930s primarily because of overly restrictive fiscal and monetary policies during the course of a major recession and because thousands of banks were not able to avail themselves of the discount window at the Federal Reserve. Since then, we have established a federal deposit insurance system to reassure depositors, created the SEC to regulate securities firms, strengthened bank examination and regulation, and, through the Monetary Control Act of 1980, made the discount window available to all depository institutions.

In view of those reforms, we do not believe the Glass-Steagall prohibitions should be maintained. They serve principally to shield securities firms from competition at the expense of the American public. At the same time, we recognize that political reality may require a less ambitious reform. That, in our judgment, would be far preferable to no progress at all.

While the issue of broader powers for banks is sometimes characterized as a "big bank" issue, we could not disagree more. This issue should be of concern to banks of all sizes and their customers. For example, since permitted to do so in 1982, some 1,200 banks have begun offering the public discount brokerage services at commissions ranging from 40 to 60 percent lower than those available at full-service brokers. Similar benefits have been realized by life insurance purchasers in New England and New York where savings banks profitably underwrite and sell life policies at rates among the lowest available anywhere. Small banks without the managerial or financial resources to enter these new businesses alone are often able to do so through joint ventures or the purchase of packages assembled by others.

Competition, Safety and Concentration

To promote stability and competition in financial markets, we must have as many viable competitors as possible. In our judgment, the ideal system is not one in which 15,000 competitors are artificially preserved in small banking markets by protective laws. Nor is the ideal system one in which only a handful of firms survive and operate in a giant, national arena. We favor a system without artificial barriers to lock firms into and out of markets, but one with much more vigorous antitrust enforcement than is possible under current laws.

For example, we believe it would be clearly procompetitive for one of the nation's largest banking organizations to enter a major new product or geographic market on a de novo basis or through a foothold acquisition. On the other hand, the competitive benefit would be nonexistent, or at least much less clear, if it were to enter by acquiring one of the large, established competitors in that market. Yet, current antitrust law largely ignores the long-range structural or concentration effects of an acquisition and would not, in all probability, preclude quite sizeable combinations.

We are concerned about this issue not only from the standpoint of competition, but also from the viewpoint of the safety of our insurance fund. Like any insurer, we want our risk diversified as much as possible and spread among as many institutions as is reasonable.

For these reasons, if artificial barriers to product and geographic expansion by banks are dismantled by the Congress, state legislatures or marketplace developments, we believe it essential that our antitrust laws be strengthened. The Judiciary Committee will likely have to address this subject to fashion a comprehensive, longer term solution. In the meantime, the Banking Committee could take care of short-term needs by placing tight restrictions on the permissible size of acquisitions or affiliations by our largest banking organizations, say the top 25 or so. While S. 2181 addresses this issue, it appears it would not be particularly effective in restraining acquisitions or affiliations by or among the largest firms.

Strong antitrust enforcement, in addition to protecting the public and the deposit insurance fund, would promote competitive equity between banks and their nonbank competitors. An obvious element in that fairness equation would be to permit nonbank financial firms to affiliate with banks to the extent banks are permitted to affiliate with nonbank financial firms. It should be a two way street, open to all competitors. For firms that do not conform to the new rules, whatever they may be, we would require divestiture of nonconforming activities within a reasonable period of time, perhaps 10 years as was required under the Bank Holding Company Act Amendments of 1970. We do not believe in permanent grandfathering. Either there is a problem with certain affiliations or there is not. If there is not, they should be permitted. If there is, they should be prohibited across-the-board. The date an affiliation was created should be irrelevant except possibly in determining the length of time permitted for divestiture.

Deposit Insurance Reforms

Mr. Chairman, the fundamental premise upon which we at the FDIC are operating is that the public wants stability in the banking system. The cornerstone of that stability is the deposit insurance system. In considering the issue of deregulation, we must also address the measures necessary to maintain the vitality of our federal deposit insurance system.

Last year you introduced legislation -- S. 2103 -- designed to do just that. The thrust of the bill is to foster a greater degree of marketplace discipline in the banking system, while also strengthening our supervisory powers. These steps are essential if we are to maintain stability in the absence of rigid government controls on competition such as Regulation Q, which has been almost completely phased out.

S. 2103 would authorize the FDIC to replace the present system of fixed-rate deposit insurance premiums and rebates with a system in which the rebates vary according to bank risk. It also proposes that banks be charged for all above-normal costs of supervision, such as the more frequent examinations that problem banks require. Requiring problem banks to pay more for deposit insurance and supervision, instead of spreading the cost among all banks as we do now, would provide an incentive for banks to correct their problems promptly and would certainly be more equitable than the present system. These are not drastic proposals, but they represent steps in the right direction.

S. 2103 would also provide the FDIC the tools it needs to limit its exposure to loss in problem banks by granting the FDIC the authority to take the full range of enforcement actions against any bank it insures. Today we have that authority only with respect to state nonmember banks which, due to their generally small size, present the least exposure to the insurance fund.

I might note that we recently entered into cooperative examination programs with the Comptroller of the Currency and the Federal Home Loan Bank Board for federally chartered banks and thrifts insured by the FDIC. These programs will be of tremendous benefit in helping us to monitor our exposure in banks we insure and to prepare in an orderly way for their failure where it cannot be avoided. These two agencies are to be commended for putting the overall good of the system ahead of interagency political concerns. It is our hope that a similar arrangement can be worked out with the states and/or the Federal Reserve for state member banks.

We believe that one of the most effective ways to control destructive competition and excessive risk-taking in a deregulated environment is to expose banks to the discipline of the market, an ingredient that the working of the deposit insurance system has tended to stifle. A promising potential source of market discipline is large depositors, those with deposit balances in excess of the $100,000 insurance limit. Although we refer to them as "uninsured" depositors, in practice we have for years provided them *de facto* 100 percent coverage in most failures, especially failures of larger banks.

This results from our practice of merging failed banks into other banks. Currently, uninsured depositors, particularly at the larger commercial banks, do not feel they are at risk since they recognize the FDIC prefers to handle these failures through mergers. If uninsured depositors are to have sufficient incentive to monitor bank risk, this perception by uninsured depositors must be altered.

One way this could be done is for the FDIC to pay off insured depositors in all failed banks. However, paying off a large bank can pose significant problems. Most notably, uninsured depositors typically must wait several years before they receive any significant payment on their claims. This could prove very disruptive to the payments system when a large bank is involved.

To alleviate these problems, the FDIC has tried a procedure under which a payoff was accomplished by transferring insured deposits to another bank for a premium, and a cash advance was made nearly simultaneously to uninsured depositors and other general creditors based on the present value of anticipated collections by the receivership. Under this type of transaction, disruptions in the financial markets are kept to a minimum while exposing uninsured depositors to some risk of loss. As a result, the depositors have a strong incentive to select the soundest institutions, rather than simply the largest ones or those paying the highest interest rates. We have not completed our evaluation of this new procedure. If it proves successful, we will provide ample public notice before implementing it as a matter of course.

Our efforts to encourage more discipline in the banking system will be undermined if nothing is done to limit the practice of brokers sweeping the nation for funds and placing them in banks that pay the highest rates of interest irrespective of the condition of the banks. Competition in banking should not be based solely on the rate of interest paid. Consideration should also be given to such factors as capital adequacy, asset quality, the degree of insider lending, competence of management and the quality of service. Brokers and their investor clients have little reason to consider these other factors because the existence of the FDIC guaranty interferes with the normal working of the marketplace by eliminating risk.

As a consequence, the FDIC and the Federal Home Loan Bank Board have jointly proposed changes in our insurance regulations to limit the federal guaranty on brokered deposits. The rule, if adopted in final form, will be effective October 1, 1984, in order to allow a reasonable transition period.

Our proposed regulation will not be a panacea. There will be ways for some entities to bypass it. For example, a credit union with $2 million to invest could, rather than going through a broker, place the funds directly in the 20 banks that pay the highest interest rates and obtain full insurance in the process. Our proposed regulation would make this more difficult and less efficient, but not impossible. Moreover, our proposed regulation would do nothing to limit the insurance coverage on trusteed deposits placed by organizations such as the Bureau of Indian Affairs in problem banks throughout the country. Our lawyers are currently considering additional regulatory or legislative solutions to curb these outright abuses and misuses of the deposit insurance system. If we conclude legislation is necessary to address these problems, we will promptly submit an amendment to S. 2103.

There are several other provisions in S. 2103 that we consider important. Rather than addressing each item individually, let me just say that we believe reform of the deposit insurance system is tied inextricably to the issue of bank deregulation. We do not believe the two topics can or should be separated. In the strongest possible terms, we urge Congress to consider our proposals for reform of the insurance system in S. 2103 right along side S. 2181 and S. 2134.

Miscellaneous Provisions

There are other collateral issues that are raised by S. 2181 and S. 2134. Because our testimony is already more lengthy than we desire and our views on the additional matters are reasonably well known, I will simply highlight a few of them. Interest on all reserves maintained at the Federal Reserve should be paid at market rates, in our judgment. We would recommend a phase-in to cushion the federal budget impact. Banks and thrifts should be authorized to pay interest on checking accounts, but only if this action is taken in the context of an acceptable comprehensive bill. We believe that if we are to maintain a separate regulatory and insurance system for thrifts, the definition of a "thrift" must be tightened through adoption of a strict asset test based on mortgage lending activity. We also believe that the FDIC and FSLIC should be directed to adopt uniform capital standards and accounting rules for federally insured banks and thrifts, to be phased in over the next several years to allow thrifts an opportunity to recover from their severe losses in recent periods. Assuming Congress is not able to address the McFadden and Douglas restraints at this time, we would support legislation to sanction reciprocal interstate banking pacts entered into by the states, and we would not "sunset" this provision. Finally, we would support legislation to prohibit the states from empowering their banks to engage in activities outside the state that are banned or limited within the state.

Conclusion

Mr. Chairman, in preparing this testimony I gained a new appreciation for the problems you and your colleagues face in attempting to deal with the subject of bank deregulation legislatively. It is a vast and complex subject. There are no clearly right answers or solutions.

The process requires that we balance a number of factors. We have attempted in our testimony to identify those factors and give our judgment about where to strike the balance. We recognize that others with different or perhaps more focused perspectives would strike a different balance. We will be as flexible as possible in accommodating our views to those held by others. We want legislation, and we want it as soon as possible.

Except for moratorium legislation, it is hard to imagine the Congress adopting any bill that would be worse than the *status quo*. The marketplace is deregulating, and, try as one might, it cannot be stopped.

As a practical matter, our choice is not between deregulation and re-regulation. Our choice is between unplanned, helter-skelter deregulation and more orderly deregulation in which Congress acts to protect the public interest. As difficult as the legislative process is certain to be, we owe it to the American public to travel that route.

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429
Office of Congressional Relations and Public Information

Years of Confidence
1933 – 1983

April 10, 1984

ADDITIONAL COMMENTS ON S. 2181

TITLE I -- FINANCIAL INSTITUTIONS COMPETITIVE EQUITY

Expanded Powers. - As stated in our March 21 testimony, we believe that activities conducted on an agency basis, such as real estate, securities and insurance brokerage, pose minimum questions as to safety and soundness. Banks should be authorized to conduct those activities directly. We do not favor the mandated transfer of securities brokerage activities, or of other securities activities presently engaged in by banks directly, to a securities affiliate as required by S. 2181, but would not require that the affiliates be holding company subsidiaries as opposed to bank subsidiaries.

Other activities, such as securities and insurance underwriting and real estate development, pose more significant risks and should be engaged in only through separate and distinct affiliates of a bank. We, therefore, favor permitting separate securities affiliates to underwrite municipal revenue bonds and mortgage-backed securities and to operate mutual funds as provided in S. 2181, but would not require that the affiliates be holding company subsidiaries as opposed to bank subsidiaries.

While supporting the bill's expansion of Federal Reserve authority to empower bank holding companies to engage in activities deemed to be "of a financial nature," we would strongly urge that the insuring agencies be expressly granted flexible rulemaking authority to place appropriate restrictions on the exercise of such powers to the extent they may adversely affect the safety and soundness of insured banks or thrifts in the holding company organization.

As the committee knows, various state legislatures have authorized state banks to engage in a variety of these activities - or are a actively considering such legislation. Anticipating the need to exercise some supervision over these activities the FDIC on August 30, 1983 issued an Advance Notice of Proposed Rulemaking requesting comment on possible problems of safety and soundness associated with these activities. We have now analized those comments. Attached hereto is a staff summary of the comments received which we hope will be useful to you in considering the authorization of expanded powers.

While it is obvious that many of these comments in response to our advance notice are either general objections to change or general support for expanded powers -- arguments the committee is all too familiar with -- there are enough constructive suggestions to lead to some preliminary conclusions.

Some preliminary conclusions would be:

Travel Services

Engaged in for many years by a number of banks with no threat to safety and soundness.

EDP Services

The Federal Reserve determined some years ago that certain EDP services are closely related to banking. We do not see any serious safety and soundness problems with the provision of these services.

Real Estate Brokerage

Conducted either in the bank or a subsidiary offers an opportunity for improved customer service and increased profits to the bank with few problems of safety and soundness. Regulatory authority to prohibit tie-ins would be appropriate as the anti-tying provisions of the Bank Holding Company Act would not reach a bank not in a holding company.

Real Estate Investment and Development

We consider these activities to involve sufficiently greater risk that they should be conducted in a subsidiary. We are still weighing the risks but we believe regulatory discretion is desirable as situations will vary.

Insurance Brokerage

As with real estate brokerage we see little threat to safety and soundness and considerable opportunity for service to the public and additional profits to the institution. It should be noted that banks in towns of under 5,000 have long been authorized to sell insurance. We have not found this activity a problem nor have we felt it necessary to issue regulations related to it, with the exception of addressing the disposition of premium income relative to the sale of credit life insurance.

Insurance Underwriting

As with real estate investment and development this activity seems to involve sufficient additional risk to justify a requirement that it be conducted in a subsidiary. This also facilitates the regulatory process. We are still assessing possible risks associated with this activity.

Powers of State-chartered Institutions. -- Some states have adopted or are considering legislation authorizing state-chartered institutions to engage in activities not permitted under federal law. S. 2181 approaches this problem by prohibiting the conduct of state-authorized insurance activities outside a particular state on terms different than what is authorized to be done in that state. We support this measure.

Anti-tying provision. - The Sherman Act, the Bank Holding Company Act and the Home Owners' Loan Act presently prohibit a depository institution from tying its services to other services offered by it or an affiliate. Injured parties and those threatened with loss or damage may sue for triple damages and injunctive relief. We believe that these anti-tying provisions currently in effect are adequate, particularly if the artificial statutory barriers to competition in the financial-services field are eased or dismantled, coupled with stronger antitrust measures directed against undue concentration of financial resources. The best protection against tying practices is more competition. At the same time, we have no objection to providing express authority for trade organizations to bring judicial action to enforce anti-tying provisions in existing law.

Definition of "Bank". - As recommended in our March 21 testimony, we believe that any institution that receives deposits and holds itself out to the public to be a bank should be required to have federal deposit insurance and be regulated as a bank. Nor do we think any special provisions should be made to exempt any particular class of bank from otherwise applicable provisions of the Bank Holding Company Act. Accordingly, we do not favor the "consumer bank" concept incorporated in S. 2181. We also believe that no grandfathering should be provided for any institution meeting whatever definition of "bank" Congress finally decides upon. Any necessary flexibility to accommodate *faits accomplis* can, we believe, be achieved by appropriately drafted divestiture provisions.

Title IV. -- Competitive Savings Incentive

Payment of interest should be required on *all* reserves. We have long been in favor of the payment of interest on reserve balances by the Federal Reserve or the reduction in reserve requirements, or both. A unique opportunity now exists to provide for the payment of interest on all required reserve balances at market rates.

This could be phased in to modify the budget impact and would be more equitable and simpler than the more limited approach proposed in S. 2181. The burden of reserves would be nearly eliminated, providing for increased competitive parity in financial service markets. Payments on all reserves also would be a simpler solution, effectively eliminating artificial incentives to shift funds from one type account to another type.

Title VI. -- Fair Deposit Availability

The FDIC has been a strong advocate of full disclosure of business practices and corporate condition as a means of facilitating intelligent consumer choices of firms with which to do their business. At the same time, the FDIC has objected to legislative or regulatory requirements to achieve these objectives where the costs of compliance exceed the benefits derived.

Title VI would impose significant disclosure costs on depository institutions and subject them to civil penalties and class action suits for failure to comply. While there have been some "horror" cases exposed, it is not clear from evidence currently available that abuses of check-clearing policies are widespread, nor are we aware of any statistically valid information regarding losses on bad checks or the time actually required to determine the collectibility on checks deposited.

During the past five years the number of complaints involving delays in the availability of funds has consistently represented only about one or two percent of the total number of consumer complaints received by the FDIC. In 1982 and 1983 complaints regarding delayed funds availability numbered 20 and 13 respectively, again representing less than two percent of total complaints.

Recognizing public concern about check-crediting policies, both the American Bankers Association and the Independent Bankers Association of America have urged their members to make full disclosure of their policies to their depositors. In addition, the bank regulators have recently issued a notice to all banks to urge full disclosure (copy attached).

We are reluctant to prescribe statutory remedies if disclosure by financial institutions will cure most of the problems. Statutory requirements will be less flexible than market-established schedules in adjusting to changes in technological and other factors that influence the time required to complete the collection process. Given the present diversities in geographical locations, transportation facilities, use of technology and banking structure in this country, a single, uniform availability schedule could prove inequitable or extraordinarily complex. If there is any way to avoid the type of regulatory morass we have experienced under Truth-in-Lending, we should do so.

Title VIII. -- Interest on Demand Deposits

In principle, the FDIC supports the payment of interest on demand deposits. We think that this authority, however, should be provided only as part of a package including expanded asset powers and payment on interest on required reserves. We also believe that the interest ceiling on demand deposits should be phased out in coordination with the ceilings on MMDAs and transaction accounts.

Title X. -- Interstate Banking

The FDIC has maintained a position of neutrality regarding the question of permitting interstate banking. Realistically, we recognize that the barriers imposed by McFadden-Douglas have been severely eroded by a host of developments and that present and emerging technology will further erode these barriers in the near future. To avoid uneconomic distortions it seems appropriate to begin to accept the facts of life by enacting the provisions of Title X, which would sanction reciprocal interstate banking pacts. However, we would recommend deletion of Sec. 1007; once the process has started we do not see the merits of sunsetting it. Among other things, it would unjustly reward those who made their acquisitions prior to the sunset date and give them an incentive to oppose renewal of the provision.

SUBJECT: Comment Summary and Recommendations in Response to Advance Notice of Proposed Rule-Making re: Real Estate, Insurance, Data Processing, Travel Agency, and other Financially Related Activities on the Part of Insured Banks, their Subsidiaries, and/or their other Affiliates

On August 30, 1983, the Board of Directors adopted the above captioned Advance Notice of Proposed Rulemaking which was designed to solicit comment on the need for rulemaking to govern the direct or indirect involvement of insured banks in the subject activities. The notice, which was directed to all insured banks in order to obtain the broadest possible discussion of all the issues, posed sixteen specific questions inviting comment, among other things, on the safety and soundness of such activities, whether or not the activities present conflicts of interest, whether or not the activities are inconsistent with the purposes of Federal deposit insurance, and whether or not the activities are totally inappropriate for insured banks and/or their subsidiaries or affiliates. In the notice FDIC also sought comment on two broad issues: (1) what if any guidelines or regulations should govern the direct or indirect involvement of FDIC insured banks in expanded financial activities, and (2) what if any limitations should there be on the ownership of insured banks by companies engaged in such activities. (A copy of the Advance Notice is attached for your convenience.)

A total of 155 comments were received over the 60-day comment period which closed on November 14, 1983. Comments were still being received as late as January 16, 1984. Late comments have been included in the total count and are included in the summary.1/ The majority of the comments responded to some or all of the sixteen specific questions although most did not elaborate as to any one particular activity referenced in the notice. The following is a capsule summary of the comments which responded on a per question basis.

Question 1 - If insured banks enter into expanded activities, existing safeguards against conflicts of interest that could arise are adequate (27); existing safeguards are not adequate (4).

Question 2 - FDIC should impose a disclosure requirement as to conflicts of interest (29); should not do so (5).

Question 3 - FDIC should permit dual employment relationships (20); should not permit dual employment relationships (7).

Question 4 - There will be problems of overlapping regulation if banks enter into expanded activities (5); these problems would be extenuated if the activity is conducted in-house (3); regulatory differences will lead to competitive inequalities (2). (The general consensus of the comments addressing the issue is that the subject activities should be supervised on an equal basis i.e., banks and non-banks should be subject to the same rules of the game.)

Question 5 - The subject activities should be conducted in separate subsidiaries (11); the activities are not necessarily safer if conducted in a subsidiary (8); whether are not the activities should be placed in-house or in a subsidiary depends upon the activity in question (6); insurance underwriting activities should be conducted in a subsidiary (4); real estate underwriting should be conducted in a subsidiary (4); there is no necessity for the activities to be conducted in a subsidiary i.e., banks should be able to conduct any of the activities in-house (6); banks should be able to do real estate brokerage in-house (9); banks should be able to do real estate underwriting in-house (4); banks should be able to do insurance brokerage in-house (11); banks should be able to do insurance underwriting in-house (3).

1/ The comments were distributed among the following; 86 comments from banks and/or banking associations; 6 comments from savings and loans and/or savings and loan trade associations; 24 comments from insurance agents and/or insurance trade associations; 4 comments from travel agencies or travel agency trade associations; 1 comment from an EDP association; 12 comments from realtors or real estates associations; 10 comments from state officials and/or state bank supervisory agencies; 6 comments from individuals; and 6 comments from "others". Included in the last group is a comment from the Antitrust Division of the Department of Justice.

Question 6 - There are fundamental differences between banks and companies that engage in the subject activities (4); there are no such fundamental differences that require the subject activities to be conducted in a subsidiary (13); there is no significant difference between banking and data processing and banking and travel agency services that would warrant precluding these activities to banks (11); there are significant differences between banking and insurance (4); no such differences exist (1); there are significant differences between banking and real estate (2); there are no such significant differences (1).

Question 7 - Section 23A type restrictions should be imposed on bank subsidiaries (9); any such restriction should be left to the states and not be imposed by the FDIC (3); no such restrictions should be imposed (15); such restrictions are appropriate in some cases (3).

Question 8 - A bank's investment in a subsidiary conducting such activities should be limited (14); should be limited in accordance with the activity (2); should not be limited (13); any such limitation should be left to the states (1).

Question 9 - A bank's investment in a subsidiary that conducts such activities should be considered a part of the bank's regulatory capital (15); should not be included in the bank's regulatory capital (9); the decision to include or exclude the investment from the bank's capital should depend upon the activity involved (2).

Question 10 - If the FDIC required that any such activity be conducted by a separate, adequately capitalized subsidiary, the FDIC should define what constitutes adequate capital (11); FDIC should not define adequate capital (16); should leave the definition to the states (1); should define adequate capital if the industry in question does not itself establish capital requirements (1).

Question 11 - FDIC should impose a prior approval requirement before an insured bank can directly engage in any such activity or establish a subsidiary to do so (8); should not impose a prior approval requirement (22).

Question 12 - Rather than an approval requirement, the FDIC should simply require notice (29); should not require prior notice (1).

Question 13 - There should be no limitation on bank entry based upon bank size, camel rating, etc. (16); such a limitation is appropriate depending upon the bank's size and rating (5); depending upon size only (1); depending upon rating only (8).

Question 14 - Entry into the activities in question should be considered a change in character of the bank (2); should not be considered a change in character of the bank (16).

Question 15 - FDIC should consider the initiation of such activities as inconsistent with Federal deposit insurance (1); consistent with Federal deposit insurance (18).

Question 16 - The existing anti-trust laws are adequate to address any concerns arising from bank entry into such activities (17); are not adequate (2); bank entry into these areas shoold be limited to de novo entry (1); should not be limited to de novo entry (11).

In addition to the above, we received comments generally as follows: (20) comments against FDIC adopting any guidelines or regulations; (8) comments for action on FDIC's part; (7) comments indicating the the state rather than the FDIC should act; (9) comments urging the FDIC not to place any limitation on the ownership of an insured bank by a company engaged in any of the listed activities; (5) comments indicating that such a limitation should be imposed; (1) comment indicating that any such restriction should come from Congress and not FDIC; (25) comments urging the FDIC to adopt a liberal stance that would permit banks to compete with non-bank firms and give banks added earning sources; and (10) comments totally opposed to bank entry into non-banking activities.

Virtually none of the comments responded to our request for assistance in distinguishing between banking and commerce, however, several urged that FDIC act to maintain the separation between the two. Courier, leasing, and management consultant services were identified in the notice as examples of "other financially related services." No other services were identified by the comments as further examples of financially related services. Courier services were favored by (3) comments; leasing by (2); and management consulting by (3) one of which indicated guidelines might be advisable; and (1) comment opposed bank entry into management consulting. We did not receive any comments responding to our request for assistance in defining what constitutes the financial services industry i.e., "what standards should be used to differentiate between commerical banking, other financial services, and commerce in today's changing environment."

Comments Addressing Insurance Activities:

We received a total of 29 comments that solely addressed whether insured banks should be permitted to directly or indirectly engage in insurance activities. The majority of those commenting (17) were insurance agents, insurance trade associations, and/or insurance companies. We received 3 informative letters concerning the long standing operation of life insurance departments by mutual savings banks in the states of New York, Massachussetts, and Connecticut. (See discussion below.)

The comments in this group were overwhelmingly opposed to bank entry into insurance activities for the following reasons: bank entry will lead to express and implicit tying arrangements, will give banks an unfair competitive advantage, will lead to economic concentration, will present regulatory conflicts, and will adversely affect banks as insurance activities are inherently risky. Although most of these comments came from "interested parties" (i.e. the insurance industry), some banks did express the same concerns.

We did receive comments supportive of bank entry. An Arkansas banker wrote in stating that his bank has engaged in insurance activities for years without any problems. Six other comments opined that insurance activities do not pose safety and soundness problems and that those activities are especially appropriate for the small community bank. We also received comments from several Nebraska bankers indicating that banks in Nebraska have conducted both insurance and real estate brokerage for years without evidence of any tying abuse. An Indiana banker wrote in stating that his bank has engaged in both the travel agency and insurance brokerage business without incident for twenty-five years. He commented, however, that both businesses require specialized management.

Among the comments responding individually to the sixteen questions, two indicated that bank insurance activities will lead to undue economic concentration, three indicated that bank entry into insurance activities should be completely blocked, two felt insurance activities will pose regulatory conflicts, three indicated insurance underwriting would pose a safety and soundness problem, and eight indicated insurance brokerage would not present any safety and soundness problem.

Massachusetts and New York have permitted mutual savings banks to operate life insurance departments since 1907 and 1939 respectively. In Massachusetts the life insurance departments both sell and underwrite life insurance. In New York the life insurance departments issue policies, collect premiums, invest income, and sell and service policies. The New York Savings Bank Life Insurance Fund develops life insurance products, establishes underwriting rules, and underwrites policies. In both states the life insurance departments maintain separate assets and separate accounting and other records. In New York the life insurance departments are examined by the state banking and state insurance departments and personnel selling life insurance must take the same examination required by the state of any seller of insurance. The systems in New York and Massachusetts are said to have operated without significant problems from their inception and have added to bank income. Although the letter did not provide us with details, we did receive a response from the Savings Life Insurance Company of Connecticut indicating that it has operated in the state since 1942. The company is described as a life insurance company that has "a number of issuing and agency banks". The company is subject to review by both the state insurance and state banking commissioners.

Mortgage Guarantee Insurance

The Investors Mortgage Insurance Company, a mortgage guarantee company, sent in a detailed description of the mortgage guarantee industry and urged FDIC not to permit bank entry into the mortgage guarantee market. According to the comment letter, the mortgage insurance industry requires substantial long-term capital (the Federal Home Loan Mortgage Corporation eligibility requirements for private mortgage insurers requires that risk exposure not exceed twenty-five times the amount of the company's capital, surplus, and contingency reserves); premiums are "locked-in" and not available for use by the insurers (in many states one half of each premium dollar must be set aside in a contingency reserve for ten years and may be used only for catastrophic claim losses during that period); increases in dividends are typically limited by regulation; premiums are fixed for the term of the mortgage loan; industry losses and expenses have dramatically increased over time (1979, 55%; 1980, 64%; 1981, 77%; 1982, 108%; and of the first six months for 1983, 116%); and in order to diversify risks, the mortgage insurer needs to attract business over a wide geographic area i.e. preferably a national market.

The comment stresses that underwriting mortgage insurance is not simply an extension of the credit-making process (i.e., it involves very different considerations) and outlines the following potential abuses and concerns associated with bank entry either directly or indirectly into this industry: (1) if a bank is affiliated with a mortgage insurer, the bank's desire to originate mortgage loans may lead to pressure on the affiliate to except poor or relaxed underwriting standards; (2) the affiliated insurer may insure loans originated by mortgage bankers, real estate brokers, developers and builders with whom the bank wishes to expand its commercial lending business despite the fact that these loans are poor underwriting risks; (3) the bank could purchase or refinance problem loans insured by the affiliate in order to help the affiliated insurer over financial difficulties; (4) as the industry is capital intensive and investments cannot be liquidated quickly without great loss, the bank may be inclined to make further investments in the affiliated insurer hoping to assure its ultimate success when it would be more prudent to not do so; (5) if the affiliate is the principal insurer for the bank's own portfolio and the portfolio of its correspondent banks, a failure of the insurer could have an extremely adverse impact upon the bank and the correspondents; and (6) as banks have strong local and at best regional ties, it is likely that any mortgage insurance business entered into would be excessively concentrated and thus would expose the bank, or its affiliated insurer, to extreme risk.

Another comment dealing with mortgage guarantee insurance which was submitted by the Mortgage Insurance Companies of America also urged FDIC to prohibit bank entry into mortgage insurance or at least to prohibit a related mortgage insurer from insuring the mortgages of its affiliated lender. The comment explained that such a restriction is necessary because the losses against which the mortgage insurer insures typically occur when lenders are incurring their greatest losses on loans. The risk of loss would thus not have been diverted outside the financial family if the lending bank's portfolio is insured by a "captive" insurer. Submitted along with the comment was a paper titled "Establishing Reserves in Mortgage Guarantee Insurance", Arthur D. Little Inc., (July, 1981) which contains a well written, informative discussion of the purposes of reserves in insurance, the relationship of reserves to premium risk, and the relationship of reserves to the insured risk and solvency and solidity.

Title Insurance

The American Land Title Association urged the FDIC not to retract from its present position (codified in Part 332 of FDIC regulations) prohibiting insured nonmember banks from engaging in title insurance activities. Bank entry into title insurance was appropriately prohibited by FDIC, says the comment, because such entry poses safety and soundness and conflict of interest problems; will undermine the objectivity of title insurance underwriting and thus impair the secondary mortgage market; will adversely impact consumers; and will give banks an unfair competitive advantage. As elaborated by the comment, the placement of title insurance with a "captive" insurer will not shift the risk of title-related problems to a third party; the bank may still utilize the captive insurer when the insurer's financial ability to meet claims is at question; the bank may "send" title insurance business to the captive insurer in order to avert the failure of the insurer; the failure of the captive insurer when that company insures the majority of the bank's mortgage portfolio may adversely affect the bank; the captive insurer may issue policies on poor risks in order to prevent the bank from losing the loan business; independent title insurers may be forced to use captive title insurance agents in order not to be precluded from large blocks of the market thus setting the stage for a decline in underwriting standards; consumers may be "directed" to a captive insurer out of self interest rather than because the insurer's product is competitive or will meet their needs; and insurance premiums may go up if an independent title insurer is forced to "bid up" the portion of a premium retained by a captive agent i.e., the insurer's increased costs will be passed on to consumers.

Comments Addresssing Real Estate Activities

Relatively few comments were received that solely addressed bank entry into real estate activities. Without exception these comments came from realtors or real estate associations. The comments were opposed to bank entry into real estate underwriting or brokerage for the following reasons: (1) banks will have an unfair competitive advantage, (2) bank entry will lead to economic concentration, (3) banks will engage in unlawful tying arrangements, (4) real estate activities can require sizeable investments and profits are speculative, and (5) bank entry into real estate underwriting or brokerage necessarily leads to conflicts of interest that will harm consumers. Several comments indicated a concern that banks might use their mortgage portfolios as a listing tool if banks are permitted to enter the real estate brokerage area.

Comments Addressing Electronic Data Processing Services

Very few of the comments discussed the data processing area. One lengthy comment received from the Electronic Data System Corporation warned against simply authorizing banks to provide electronic data processing services. Such an authorization, indicated the comment, would be overly broad and would permit a bank to offer the public purely economic data processing (e.g. catalogue shopping, business planning, product analysis, economic data base services, general purpose data processing, general ledger services, and raw computer power (i.e. time sharing)). The comment recommended that any authorization for data processing on the part of banks be defined by the services offered and not the type of data processed.

The comment went on to cite certain abuses that may arise when a bank, a bank subsidiary, or a bank holding company or any of its subsidiaries offers EDP services. Those dangers include full relationship pricing (i.e., the more business the customer conducts with the bank, the lower his/her EDP costs per service), cross-selling of products, and compensating balances in conjunction with free or below cost EDP services. The comment recommended the following restrictions to protect against these abuses: (1) that banks not advise borrowers of the availability of EDP services from the bank or from an affiliate or subsidiary of the bank unless specific inquiry is made; (2) that bank employees not receive additional compensation if a customer utilizes the EDP services of the bank, its affiliate, or its subsidiary; (3) that the bank not make its customer list available to the EDP subsidiary or affiliate; and (4) that EDP services be priced on an explicit fee basis and are structured as individual profit centers (i.e. all bank/EDP customers must pay for EDP services rather than paying for services on an implied earnings basis). It was suggested that EDP services should be located, if at all, in a subsidiary of a bank holding company as that structure would help to insulate depositors' funds from risk and at the same time should not impair the subsidiary's competitive position. The comment also indicated that a bank holding company subsidiary will be less able to unfairly exploit the advantages that flow from having a credit granting franchise.

Comments Addressing Travel Agency Activities

Few comments were received that specifically addressed the travel agency business. An Illinois banker wrote in indicating that his bank entered the travel business fifteen years ago through a separate department of the bank. The travel agency department has not been profitable but has been a way through which the bank could compete for commercial depositors. A Connecticut trust company indicated that it has been in the travel business for thirty-one years and has also found the operation not to be terribly profitable. An interesting comment from the former General Counsel for the Association for Bank Travel Bureaus indicated that, as of 1974, twenty-four states permitted banks to offer travel agency services.

Associated Travel Nationwide (an association of thirty-seven travel agencies) filed a comment indicating that the FDIC should prohibit bank entry in the travel agency business as: (1) the air transporation industry is presently in turmoil due to deregulation, (2) travel agents do have financial risks, (3) the Air Traffic Conference rules prohibit dual employment, and (4) the travel agency business is a commercial and not a financial enterprise. Another comment from a travel agency indicated that bank entry into the travel agency business is not proper, will give banks an unfair competitive advantage, that existing anti-trust laws are insufficient safeguards, and that regulatory conflicts could arise.

OTHER COMMENTS OF INTEREST

American Bankers Association

The FDIC should not be in the business of determining what new powers are appropriate for banks nor in the business of limiting powers granted to banks by states or Congress without clear enabling legislation to do so. The activities under consideration are not more risky than any traditional banking activity nor are they beyond the expertise of bankers. As nonbank banks are probably not subject to the Banking Holding Company Act Amendments concerning tying arrangements, FDIC should act to cover this loophole. In general those provisions are broad enough to cover any of the new activities and they do provide the extraordinary remedy of a private right of action.

In general the ABA does not believe a disclosure requirement will serve any useful public purpose. Although a dual employment situation can give rise to conflicts of interest, those conflicts are best addressed by the internal policies and controls of the bank and not FDIC. The ABA will not support any regulatory requirement that any new activity be placed in a subsidiary of the bank. The new activities should not cause any additional regulatory overlap except in an instance where an activity is conducted in-house and the FDIC imposes a requirement to which other companies in that business are not subject.

The ABA characterizes insurance underwriting as requiring highly specialized actuaries, specialized accounting treatment, and separate capital. These requirements may thus make it difficult for banks to enter insurance underwriting profitably and may suggest that the activity is best suited to a subsidiary. The ABA cautions that the FDIC may not have the authority to regulate insurance as engaged in by banks due to the McCarren-Ferguson Act.

Real estate brokerage is described as a low-risk activity with high profitability that is easy to enter and which is compatible with banking. Banks that do commercial lending possess most of the skills necessary to engage in real estate equity investment. The risks to a bank making a loan on the security of commercial real estate may be no less than the risks of making an equity investment in that same real estate. The ABA concedes that real estate underwriting and equity investment may be more appropriate for a subsidiary of the bank.

The ABA supports bank entry into the EDP business in-house as it may be more economical to use the same hardware for the bank as for third parties. The ABA describes the travel agency business as easy to enter, requiring low capital, one in which personnel may be easily trained, and a low risk activity.

The ABA cautions that the FDIC should not make section 23A apply to bank transactions with subsidiaries as to do so could force banks to place the activity in-house which itself could give rise to greater concern depending upon the activity. Such a restriction may also put banks at a disadvantage as other companies engaged in the activity would not be limited as to the amount and type of investments that could be made in such an operation. The FDIC should defer to state law in this area. Many states already set limits on such transactions.

A bank's investment should be considered that and not be considered in the context of the bank's capital. The FDIC should not limit bank entry based upon asset size, camel rating, etc. If the conduct of a particular activity presents a safety and soundness problem to a particular bank, the FDIC can proceed under its section 8 authority. Lastly, the ABA indicates that it feels that the existing antitrust laws are sufficient to safeguard against undue economic concentrations.

The Independent Bankers Association of America

The IBAA indicated that certain regulations may be appropriate in order to safeguard the deposit insurance fund, however, the association fully supports broader powers for banks. Real estate and insurance activities will help restore lost revenues to banks if those activities are properly supervised. If the state authorizes and regulates an activity, the FDIC should not impose any additional regulations.

The Antitrust Division of the Justice Department

The current regulatory framework poses overly broad restrictions on the types of activities in which banks may engage. These restrictions impede the ability of banks to respond effectively to market forces. Expanded activities on the part of banks will help ensure the continued viability of banks and allow them to more effectively compete. There is little basis for concern that excessive economic concentration or increased anti-competitive tying will result from bank entry. Bank entry (de novo or other otherwise) should not affect the market any more than entry by any other firm. If any particular entry has a likelihood of lessening competition, existing antitrust laws are adequate. The activities under consideration are not highly concentrated (e.g. insurance and real estate brokerage are highly competitive) and economies of scale are small thus the size of the entrant will not confer any special advantage. It is furthermore unlikely that any particular lender has sufficient market power to create an unlawful tie. In any event, existing anti-tying provisions are adequate.

There are two methods by which to protect bank safety and soundness: (1) structural separation of risky activities (i.e. in a bank subsidiary or in a bank holding company should the activity be extremely risky), and (2) limiting investments. The Justice Department favors the former but does not feel that the activities under consideration are substantially riskier than traditional banking activities.

Real estate activities and insurance underwriting are probably the riskiest of the activities under consideration. The risk associated with insurance can be reduced through reinsurance and real estate risks are not excessive at least for banks with experience in real estate development lending. The Justice Department suggests that FDIC adopt a prior notice system like the one utilized for change in bank control matters. The Justice Department feels that the activities under consideration are consistent with the purposes of Federal Deposit Insurance and furthermore, that if there is any significant increase of risk of loss to the insurance fund from the activities, a risk related premium can offset that risk.

Justice supports the extension of section 23A to bank subsidiaries as there is a risk that, without appropriate restrictions on transactions between banks and their subsidiaries, the bank may engage in preferential transactions that could limit the availability of funds to nonaffiliated firms or that could adversely affect bank safety and soundness. Disclosure of conflicts of interest arising from relationships with non-banking companies are appropriate.

The Conference of State Bank Supervisors

CSBS commented that what activities are and are not appropriate for banks is solely the domain of the bank chartering authorities. Furthermore, FDIC's domain is solely to monitor banks and proceed under its section 8 authority if there is a problem.

The National Council of Savings Institutions

As bank holding companies are already subject to regulation under the Bank Holding Company Act, the Council opposes the FDIC trying to limit what firms can and cannot acquire or establish insured banks.

The California State Banking Department

California recently enacted equity investment powers for banks. The banking department is publishing for comment regulations under that state statute which will provide for effective diversification of assets, limits on the safe level of bank exposure to capital risk, and regulations which will only allow the healthiest and best run banks to engage in equity investment. The state banking department questions FDIC's authority to adopt regulations in the area and urges that the matter be left to the states.

The California Bankers Association

The activities in question are similar to those activities commercial banks have conducted for years. There is little need for regulations or guidelines and the activities do not present any inherent safety and soundness problems. The association urges the FDIC only to adopt additional requirements or regulations if experience shows that (1) existing regulations governing the industry in question and (2) FDIC's supervisory process are inadequate to protect bank safety and soundness. The comment goes on to indicate that real estate and insurance underwriting, if placed in a subsidiary, would pose no significant safety and soundness problems. As the existing Bank Holding Company Act may not permit bank subsidiaries to conduct some of the activities under consideration, banks may decide to conduct the activities in-house. This should give the FDIC more reason to be concerned about the activity. In such a case, limited safeguards analogous to lending limits may be desirable to protect depositors and the insurance fund.

The similarity of the activities under consideration with existing bank activities will ensure that management resources are not unduly diverted. The comment describes the activities in question as financial services involving primarily the management of information or risk and further states that banks are familiar with these skills.

The Association endorses insurance brokerage and underwriting on the part of banks as their experience in mass merchandising financial services will benefit consumers by reducing costs. Banks are well suited to insurance underwriting as it involves underwriting risks, investing assets, and servicing claims, something banks presently do when managing their own loan and investment portfolios. The Association opines that there are no significant differences between property and casuality insurance underwriting and the risk assessment normally conducted by banks when engaged in commercial lending. Any differences that do exist are not a problem as (1) banks can acquire the necessary expertise and (2) can reinsure the risks thus limiting their exposure. As to life insurance underwriting, the Association opines that the risks are probably lower than those for funding commercial loans.

As to real estate equity participation, the Association opines that the risks are undeniably different from those undertaken by banks in real estate lending but those risks should be manageable. The Association points to the benefits derived by savings and loans associations that have service corporations which engage in real estate activities. The Association indicates that there may be a need to place a limitation on the amount of credit and equity investment an insured bank may commit to real estate development. (In California the new statute limits the total of all loans, investments, and guarantees a bank may make to real estate developments in which the bank holds an equity investment to 10% of the bank's assets).

The Association believes in certain disclosure requirements but feels that such requirements should be left to the states. The Bank Holding Company Act Amendments concerning anti-tying are sufficient and the intercorporate transaction restrictions proposed in new section 23B may be appropriate.

The Association supports the concept of functional regulation; requests that the FDIC not define adequate capital but let industry standards do so; and suggests that the FDIC use a notice provision coupled with its supervisory oversight to preclude entry by banks where their condition or quality of management warrant such an action. The Association feels that the existing anti-trust laws are sufficient to prevent undue economic concentration.

American Council of Life Insurance

The Council believes that the appropriate role of the FDIC is to implement established policy, not create it. Further, the Council is not persuaded that events either in the marketplace or current state or federal legislative activity justify the promulgation of rules dealing with the integration of banking and insurance. The Council challenges the notion that the boundaries between banking and insurance are crumbling away. Reference is made to the Garn-St Germain Act in which Congress codified the long-standing restrictions on insurance activities by bank holding companies and their subsidiaries while permitting continuance of the limited insurance agency activities which had for many years been determined by the Federal Reserve to be "so closely related to banking as to be a proper incident thereto."

American Insurance Association

The Association is opposed to the granting of new property-casualty insurance authority to deposit-taking institutions. There are inherent problems in allowing banks to enter into the business of insurance. In particular, there are clear dangers of credit leverage abuse, multiple regulatory conflicts and excessive economic concentration. These dangers can and should be avoided by continuing the current national policy of not permitting deposit-taking institutions to underwrite or sell insurance in most cases. This policy was most recently reaffirmed by Congress in Title VI of the Garn-St Germain Depository Institutions Act of 1982. Congress is the appropriate body to make any changes in that policy.

The CHAIRMAN. Thank you, Mr. Isaac.
Mr. Gray.

STATEMENT OF EDWIN J. GRAY, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. GRAY. Mr. Chairman and distinguished members of the committee, I appreciate this opportunity to discuss with you the Bank Board's views on the legislative proposals before the committee, and the challenges we face in dealing with thrift industry safety and soundness issues in a deregulated environment.

I especially want to commend you, Mr. Chairman, for again taking the initiative and demonstrating the courage to address the revolving character of the Nation's financial system, and to reinstitute the process which several years ago led to the passage and enactment of the Garn-St Germain Depository Institutions Act. I hope your continuing search for answers to the difficult questions the financial services industry faces in the current and prospective environment will result in public policy determinations which reinforce the groundwork which was laid with the passage of that historic legislation.

As you and other members of the committee know, the Garn-St Germain Act was not intended as a panacea. The thrift industry faces a long and difficult recovery period if it is to continue its historic role as the single most important private sector force for making America a nation of homeowners down through the years.

Helping thrifts to renew their strength so they can continue to serve the housing finance and related needs of American families, while at the same time building on the time-honored concepts of safety and soundness, are the fundamental goals of the Bank Board.

Legislation which enhances and reinforces these inextricably linked objectives will serve the public interest and represent another monument to this committee's leadership.

From the Bank Board's point of view, any major legislative restructuring of financial services can best serve these goals—and the broadest public interest—if guided by four basic principles.

First, I believe legislation should reaffirm and reinforce the fundamental distinctions in the public policy missions of thrifts and banks. I can find no basis for arguments that the intent or effect of the Garn-St Germain Act was to erase the differences between these separate types of depository institutions.

The explicit language of that act makes it clear that thrift institutions are to continue to serve the public as principally home mortgage lending institutions in order to revitalize the housing industry.

Despite the limited new asset authorities granted to Federal thrifts in the act, these same institutions last year originated a record volume of residential mortgage loans. Nonmortgage investments permitted by the new Garn-St Germain asset authorities were miniscule—attaining only 1.7 percent of assets by the end of December 1983.

Indeed, the continued dedication to housing finance by FSLIC-insured institutions is clearly evidenced by their maintenance of roughly 80 percent of activity in qualifying thrift assets—far more than the 60-percent benchmark used as the litmus test for unitary savings and loan ownership under the Garn-St Germain Act.

Second, the Bank Board believes that any reform proposal must preserve and enhance, not reduce, the attractiveness of the thrift charter, in order to encourage the flow of new capital into the industry, and to facilitate the profitable use of the supplementary Garn-St Germain powers. During the last 9 months, the Bank Board has approved 118 applications for conversion from mutual to stock form. These conversions have injected $3.6 billion in new capital into the industry in 1983 alone; such conversions brought into the industry the equivalent of 10 percent of the thrift industry's entire net worth.

Preservation and enhancement of the thrift charter serves many important purposes. This is especially critical, given the industry's weakened condition, and its continuing hypersensitivity to interest rate swings.

The third major objective of a legislative initiative, from the Bank Board's perspective, ought to reaffirm the longstanding congressional commitment to preserve an independent regulatory and deposit insurance framework for true housing finance-oriented thrift lenders, with regulatory authority over such lenders and their holding companies vested exclusively in the Bank Board.

Finally, we believe an explicit ban on all combinations of thrifts with underwriters and market makers of general corporate securities is vital to preserve the unfettered ability of thrift institutions to carry out their housing finance mission, and to prevent unique risks and potential conflicts of interest which could result from such affiliations.

In light of these four major goals, we believe the framework of both pieces of legislation before the committee today provide a constructive basis for dialog at this stage of the legislative process.

In the testimony I have submitted to the committee, the Bank Board has recommended certain modifications and revisions which we believe are attendant on accomplishing the goals for the thrift industry which have been outlined.

For example, we believe an appropriate asset composition test to distinguish thrifts from commercial banks should focus on what a thrift is, and what the purpose is, that such institutions should serve. In other words, we believe such a test should be affirmative in nature.

Longstanding public policy considerations established by the Congress confer certain benefits on true housing finance-oriented thrift institutions because of the affirmative mission they play in helping to house American families.

And, while we believe certain flexibility must accompany any basic asset composition test for determining what is a qualified thrift lender, we would nevertheless argue that any litmus criteria should emphasize what the institution is supposed to do, rather than what it is not supposed to do, in order to claim the public policy benefits conferred on principally housing finance-oriented thrift institutions.

The ingredients which make up an affirmative asset composition test ought to take into account the real world operating needs of the insitituion in today's fiercely competitive environment; sufficient flexibility to also encompass the shelter needs of the elderly and the young; an understanding of the close relationship of housing-related investments to the mortgage credit function; an appreciation of the role mortgage securities play in today's housing finance arena; and sufficient elbow room to achieve profitability in reaching the overall goal of enabling the institution to play its principal housing finance-oriented role.

I would be remiss if I failed to emphasize the extremely fragile state of the thrift industry in general. Still struggling to emerge from the worst crisis in its history—a time in which a quarter of the industry's net worth was lost in just 2 years and more than 700 institutions disappeared—managements today are trying to cope with a multitude of unprecedented challenges. For institutions which were essentially limited to make long-term fixed rate mortgages in a relatively stable and regulated interest rate environment for so many years; for institutions which still carry the heavy residual burden of badly mismatched asset and liability maturities; for institutions which are struggling to restructure their portfolios in order to deal with exposure to interest rate risk—in what has become almost overnight a totally deregulated liability environment—the challenges to thrift managements are simply enormous.

It is in this same deregulated environment that we who head the Federal Savings and Loan Insurance Corporation are called upon to exercise our solemn responsibilities under the law to conserve the resources of the fund in order to preserve the credibility which the institutions we regulate must have to effectively transact business with the public.

The challenges we face, in regulating an industry which is seeking to cope with rapid change, require that we have sufficient discretionary authority to accomplish appropriate safety and soundness goals—both for the deposit insurance fund and for the industry itself.

With these thoughts in mind, I would urge the members of the committee to pay special heed to the importance of nurturing thrift recovery through prudent legislative measures which maximize the prospects of such recovery and which address the special need for assuring that the deposit insurance fund continues to inspire broad public confidence.

The testimony I have submitted to you is intended to reflect the Bank Board's continued commitment to helping the $800 billion thrift industry renew its strength, while continuing to accomplish its primary housing finance mission, consistent with safety and soundness principles.

I look forward to working with the committee to accomplish these goals.

I will be pleased to answer any questions the committee may have. Thank you.

[The complete statement follows:]

STATEMENT OF
EDWIN J. GRAY, CHAIRMAN
OF THE
FEDERAL HOME LOAN BANK BOARD

Mr. Chairman and distinguished members of this Committee:

I appreciate the opportunity to bring before you the Bank Board's views on the legislative proposals before the Committee and the challenges we face in dealing with thrift industry safety and soundness issues in a deregulated environment.

I especially want to commend you, Mr. Chairman, for again taking the initiative and demonstrating the courage to address the evolving character of the nation's financial system and to reinstitute the process which several years ago led to passage and enactment of the Garn-St Germain Depository Institutions Act.

That landmark legislation benefitted greatly from the approach you took to place the issues on the public table, to invite a widespread expression of views and to draw out a consensus sufficient to deal through the legislative process with fundamental concerns relating to the proper role of the thrift industry in America's financial system.

Your continuing search for answers to the difficult questions the financial services industry faces in the current and prospective environment -- within which depository institutions are called upon to serve the public -- is clearly intended to modernize the financial structure.

The Garn-St Germain Act moved the thrift industry into a position in which it would at least have the opportunity to compete and ultimately survive. I hope the process you have reinstituted this year will result in public policy determinations which reinforce the groundwork which was laid with the passage of that historic legislation.

It was not meant to be a panacea for the thrift industry. Rather, it was a giant step forward, because it reaffirmed the principAL role Congress wants savings institutions to play in financing the homeownership needs of American families, while, at the same time, providing limited new flexibility to undergird the financial strength necessary to support that housing finance role.

A stable and sound financial system which sustains public confidence in the strength and safety of the nation's publicly-insured depository institutions ought to be a fundamental goal of the process you and your colleagues on the Committee have reinstituted.

We at the Federal Home Loan Bank Board look forward to working with the Committee closely in the legislative refinement process during the weeks and months ahead.

Thrift institutions are intended to serve the public as private sector instrumentalities of public policy. In my view, these institutions have been the single most important private sector force for making America a nation of homeowners down through the years. Helping them to renew their strength so that they can continue to serve the housing finance and related needs of American families, while at the same time building on the time-honored concepts of safety and soundness, are the fundamental goals of this Bank Board. Legislation which serves to enhance and reinforce these inextricably intertwined objectives will serve the public interest and represent another monument to this Committee's leadership.

THE THRIFT INDUSTRY POST GARN-ST GERMAIN

Before addressing the many structural issues raised by S. 2181, the Financial Services Competitive Equity Act, and S. 2134, the Depository Institutions Holding Company Act, I would like to focus briefly on the experience of the thrift industry since enactment of the Garn-St Germain Act in 1982.

All the data available to us strongly supports the conclusion that federal thrifts have used the limited new authorities granted by the Garn-St Germain Act exactly as its drafters intended -- to gradually restructure their portfolios while continuing to maintain their housing finance role. While some have erroneously claimed that the Act somehow erased the traditional specialized mission of the thrift industry, the facts resoundingly refute such arguments.

Our figures on how federal thrifts have used the new asset powers under Garn-St Germain demonstrate very forcefully that they are proceeding in a very cautious way to supplement their traditional home lending activities. While the volume of non-mortgage lending increased substantially in many categories, the percent of change as a fraction of total assets was miniscule. All types of non-mortgage loan investments affected by the new legislation comprised 0.7 percent of total assets in June, 1982. By December, 1983, the figure had increased to only 1.7 percent of total assets.

As of December 1983, FSLIC-insured thrifts maintained approximately 80% of assets in qualifying home loans and related assets, far above the 60% minimum needed to justify unrestricted unitary status under the Garn-St Germain Act. Moreover, FSLIC-insured institutions made $138 billion in mortgage loans in 1983, more than two and one half times the volume of 1982 -- an all-time record.

But we must also caution this Committee that thrifts' struggle for financial recovery is far from over. We have seen dramatic and positive signs of increased use of the adjustable rate mortgage as a restructuring tool in recent months, and the overall health of the industry did improve last year primarily as a result of falling interest rates.

Nonetheless, interest rate swings are a sword of Damocles casting a long shadow over the future survival of the industry.

Thrifts face a difficult and fragile transition, and managers have just begun the task of restructuring their portfolios -- with the vital supplements provided by the Garn-St Germain Act -- to avoid the huge maturity mismatches which nearly drove the industry to disaster in 1981-1982. While thrifts, according to our preliminary estimates, appear to have had after-tax profits of about $2.1 billion in 1983, almost four out of every 10 FSLIC-insured institutions were still in the red. Most of the reported profits last year represent non-operating income.

A significant upward change in interest rates could again submerge the majority of thrifts in a sea of red ink. The thrift industry's ability to absorb losses under such a scenario would be highly questionable at best.

The size of the FSLIC insurance fund -- $6.3 billion -- now represents a ratio of FSLIC reserves-to-insured deposits which is far lower than historic levels. The ratio has deteriorated steadily, from a level of two percent in 1970 to around one percent today. In fact, the current reserve ratio is approaching the range which prompted Congress in 1962 to impose a costly secondary reserve additional assessment premium on FSLIC-insured institutions. However, in 1962, the industry's ratio of real net worth to liabilities was 7.6%. The so-called net worth ratio today is only 4.1%. If the accounting procedures currently permitted were eliminated, the industry's net worth would be vastly less than what is reported. In other words, these special accounting procedures have resulted in the reporting of thrift industry profits and net worth which have vastly overstated the actual operating profits of the industry. I am prepared to discuss these sensitive statistics privately with Committee members. Given the nature of emerging problems confronted by the FSLIC as a result of the growth of federally-insured brokered deposits, the current ratio of FSLIC-reserves-to-insured-deposits will likely drop further in the future.

The devastating effects of interest rate spirals over the last several years were the direct result of the asset-liability mismatches that pervaded the thrift industry. By August of 1982, 53% of the industry's interest bearing liabilities were in market rate instruments with an initial maturity of one year or less. On the other hand, 85% of the industry's interest bearing assets were in long-term, fixed-rate loans. The Garn-St Germain Act was needed to permit thrift managers to begin to balance their cost of funds with investments in an era of volatile interest rates, by allowing thrifts to better compete with unregulated firms for deposits and to allow greater portfolio investment flexibility.

REAFFIRMING THRIFTS' UNIQUE MISSION

The Garn-St Germain Act, in granting thrifts a limited degree of commercial lending and investment flexibility, did not in any sense transform federal thrifts into commercial banks or justify depriving them of the unique regulatory framework created to nurture their housing finance mission. This idea is reflected in two provisions of the Act regarding regulation of unitary holding companies and federal thrifts' interstate branching authority. In both cases, Congress imposed restrictions intended to ensure that the continued focus of the thrift subsidiaries of unitary holding companies and federal savings and loans with interstate branching privileges would remain in traditional housing finance.

Under the Garn-St Germain Act, the thrift subsidiary of a unitary savings and loan holding company and a federal savings and loan with interstate branches must meet a portfolio test established by the Internal Revenue Code for determining whether it qualifies to use the bad debt deduction established in I.R.C. Section 593. This asset test, which requires a 60% commitment to residential mortgages, liquidity, and related assets, is the benchmark for determining if full unitary powers and federal interstate branching rights are permissible in particular cases. A unitary holding company whose thrift fails the test can exercise only the powers granted multiple holding companies, while a federal institution's authority to branch interstate is prohibited except in certain instances such as those involving extraordinary supervisory acquisitions or where permissive state laws allow.

Under S. 2181, the Garn-St Germain Act concept is expanded to determine not only eligibility for unrestricted unitary savings and loan status but also to establish whether a federal thrift may operate a service corporation with the full range of powers authorized by the Board now or in the future. Thrifts meeting the asset composition test are categorized as "Qualified Thrift Lenders." Thrifts that do not meet the portfolio asset test in S. 2181 would lose current diversification opportunities available through affiliation with a unitary holding company and would be limited to those available to bank holding companies. Federal thrifts that are not qualified thrift lenders would also suffer sharp reductions in their service corporation authority. Because S. 2181 uses the Treasury's Financial Institution Deregulation Act ("FIDA") as its framework, S. 2181 also represents a significant expansion of the powers of bank holding companies in the areas of securities activities, insurance underwriting and brokerage, real estate development and brokerage, as well as "activities of a financial nature" as determined by the Federal Reserve Board. S. 2134 also expands bank holding company powers in regard to securities activities. Under both bills, there are significant exclusions from the current Internal Revenue Code list of assets used to target a primary housing focus for thrifts under the Garn-St Germain Act.

BOARD SUPPORT OF ASSET COMPOSITION TEST

While the Board has strong reservations about certain particulars of the asset composition tests used in both bills, we strongly support the principle of such a test. An asset composition test provides the most equitable and realistic means of preserving the specialized function of thrifts by distinguishing such institutions and extending to them unique regulatory benefits based on a dedication to housing finance and other housing-related investments.

We believe that such a test is a vital part of any changes in bank or thrift regulatory authorities because it recognizes the reality that thrifts and banks function quite differently in the marketplace. Such a test assures that institutions with a substantial commitment to housing finance will continue to function within a framework specifically fashioned to aid their mission. As I have frequently stated, if thrifts ever did become the equivalent of commercial banks, I do not believe there would be any sound basis for maintaining the Federal Home Loan Bank Board, the Federal Home Loan Bank System, or the Federal Savings and Loan Insurance Corporation in a separate regulatory framework.

In my view, every institution with a thrift charter, whether state or federal, should be able to pursue diversification options. However, where such diversification involves abandoning home finance as a primary mission, an institution should not be allowed to compromise the purposes of the separate thrift regulatory structure by freely availing itself of its benefits. An appropriate asset test would resolve this problem by denying future bank-like thrifts the benefits which ought to only accompany a substantial housing finance focus.

GOALS WHICH AN ASSET TEST SHOULD MEET

In my view, any legislation which reforms the current regulatory structure for insured depository institutions must be guided by four basic principles.

First, any such legislation must acknowledge the very basic differences, in statutory authorities and operating functions, between thrifts and banks. I reject any contentions that the intent or effect of the Garn-St Germain Act was to somehow transform thrifts into banks. Any objective look at what

Congress actually said about its intent, the limited scope of the Act, and what thrifts have done since its passage, proves beyond any doubt that there are vast differences in the mission and actual function of the two industries. Most significantly, the Preamble to the Act clearly states its intent "to revitalize the housing industry, by strengthening the financial stability of home mortgage lending institutions and insuring the availability of mortgage loans" (emphasis added).

Second, any reform proposal must preserve and enhance, not reduce, the attractiveness of the thrift charter, to encourage the flow of new capital into the industry and to facilitate profitable use of the supplementary Garn-St Germain powers. This is especially important given the weakened condition of the thrift industry and its continuing sensitivity to interest rate changes.

Third, any such proposal should reaffirm the long-standing Congressional commitment to preserve an independent regulatory and deposit insurance framework for true housing-oriented thrift lenders, with regulatory power over such lenders and their holding companies vested exclusively in the Bank Board.

Finally, we believe that an explicit ban on all combinations of thrifts, and underwriters and market makers of general corporate securities, is vital to preserve thrifts' unfettered ability to carry out their housing mission, and to prevent unique risks and potential conflicts of interest which could result from such affiliations.

QUALIFYING ASSETS - S. 2181

Under S. 2181, a qualifying federal thrift, with a certain percentage of mortgage and mortgage-related assets, is entitled to maintain the service corporation authority now available under the Home Owners Loan Act (HOLA). A federal non-qualifying stock thrift's service corporation authority is reduced to clerical-type activities, while non-qualifying federal mutuals' authority is frozen to activities permissible under Board regulations as of July 1, 1983. In a similar vein, the investment authority of a unitary holding company is restricted to a bank holding company "laundry list" unless its insured subsidiary is a qualified thrift lender.

A thrift becomes a qualified thrift lender if it either has (1) no more than twenty-five percent of its assets in commercial and non-residential real estate loans, or (2) no less than 60 percent of assets in loans, securities, or equity positions "related to" residential real estate and manufactured housing, and property used by the association in the conduct of its business.

In my view, the "25%" commercial lending alternative undermines the crucial goal of acknowledging and reinforcing the historic and unique differences between banks and thrifts. Indeed, the concept of defining what a thrift is not, is like saying a household cat is not a Bengal tiger. In my opinion, we ought to affirmatively define what a thrift is and what the purpose is that it should serve. While the "25%" alternative would confer "qualifying" status on virtually all existing thrift institutions, it fails to emphasize the predominant affirmative portfolio dedication to home finance which has been, and should be, the real litmus test for access to the regulatory structure designed for thrifts. I cannot emphasize too strongly my conviction that the Federal Home Loan Bank System must be preserved for home lending institutions. The "25%" alternative would undermine the foundations of that system by allowing upwards of 10,000 commercial banks to claim the status of "qualified thrift lenders." Approving this test could conceivably give commercial banks with little or no commitment to residential mortgage lending access to Bank System advances and to other unique statutory and regulatory provisions which were fashioned to support a predominant commitment to home finance. In our view, this would prove unworkable and highly counterproductive.

I believe that the concept of a "60%" housing-lending test found in S. 2181 is a far better means to delineate appropriate regulatory guidelines for the thrift and banking industries. However, we can support this concept only if the S. 2181 "laundry list" is modified in certain crucial areas.

Without certain revisions, the S. 2181 housing test could thwart the primary goal of the Garn-St Germain Act by seriously compromising the ability of thrifts with a strong housing commitment to raise capital through conversions, to restructure and strengthen their portfolios, to reduce interest rate risk through appropriate diversification, and to survive and prosper in a variety of economic environments.

Under current law, all federal thrifts may invest up to 3% of assets in service corporations which can conduct a wide array of thrift-related activities. In addition, a unitary holding company with unlimited authority may own any thrift that has invested 60% of its assets in residential mortgage loans, U.S. obligations, cash and other items set out in a "laundry list" of qualified assets in the Internal Revenue Code. These opportunities for diversification have consistently provided thrifts with vital supplementary capital and income, and have been recognized by Congress as appropriate and necessary to the health of the industry in accomplishing its primary housing finance mission.

The "60%" housing-oriented test in S. 2181 could significantly reduce this structural flexibility because the list of qualifying assets excludes a number of items now counted as "qualifying assets" under Garn-St Germain, including important liquidity investments in cash and U.S. obligations. Liquidity investments are a crucial tool for all thrift institutions, and are required by Bank Board regulations. The failure to include these liquidity-related investments in the S. 2181 "qualifying assets" test would undermine the ability of federal S&Ls to manage liquidity effectively while at the same time restructuring their portfolios to use the new supplementary assets powers provided by the Garn-St Germain Act.

In addition, because mutual savings banks have traditionally had a somewhat different portfolio structure than savings and loans, while still maintaining a much higher proportion of their total assets in residential mortgages than commercial banks, a majority of these institutions are likely to fail the Garn "60%" test. However, under the current "qualifying assets" test of the Internal Revenue Code, only about 4% of mutual savings banks are excluded. We do not see adequate justification for a test which would force savings banks to lose structural flexibility needed to support their home finance activities.

By reducing the investment options of "qualified" thrifts, the asset composition test in S. 2181 could deprive the industry of critical sources of income and capital, and diminish the value of the thrift charter. This could impede the valuable mutual-to-stock conversion process, or at the very least, diminish the amount of capital raised through conversions. In 1983, less than 80 conversions raised capital which amounted to approximately 10% of the industry's net worth.

Any legislative proposal which has even the unintended effect of diminishing the thrift charter could translate into reduced capital invested in the thrift industry and increased pressure on the FSLIC fund. We believe such results must be avoided by drafting an asset composition test which enhances thrift viability.

The Bank Board therefore strongly supports expanding the "60%" alternative of the S. 2181 qualifying assets test to include all the items now covered by the Internal Revenue Code as qualified assets. In addition, we believe the liquidity items included in the Code should be expanded to include all assets qualifying as short-term liquidity investments under the Board's regulations under the Federal Home Loan Bank Act. Because S. 2181 affords the FSLIC broad authority to interpret and regulate regarding the qualifying assets test, the Bank Board could address any potential misuse of this "laundry list" -- such as excessive concentration in liquidity items -- by imposing limits on particular types of investments. In addition, we believe it is important to expand the "60%" test to accord at least some level of credit to thrifts which support housing through originating loans and selling them in the secondary market, while generating servicing fee income. Thrifts which have a substantial portfolio investment in home loans as well as significant secondary market activity should not be arbitrarily deprived of qualified status. This added flexibility would allow managers to cope with volatile economic conditions which may dictate higher levels of secondary market activity as a means of offsetting losses arising from maturity mismatches which are a continuing threat to the thrift industry.

CHANGES TO CURRENT I.R.C. ASSET TEST LINKED TO BAD DEBT DEDUCTION

We realize that changes to the tax code are not within this Committee's jurisdiction. However, we think it is important to note that the changes we are suggesting to the "thriftness" test for S. 2181 and S. 2134 should logically be incorporated in the current Internal Revenue Code provisions which determine whether a thrift is eligible for the Section 593 bad debt deduction (using the percentage-of-taxable income method). The industry's ability to prosper and sustain its commitment to housing lending can only be ensured by providing consistent treatment in both our tax laws and the special regulatory framework designed for thrifts.

Consistent with the broad language of S. 2181, classifying as qualifying assets those loans, equity positions, or securities "related to residential real estate" (including investments of subsidiaries), we believe I.R.C. Section 7701(a)(19)(C) should be modernized to include the same investments, including:

1. All investments related to shelter facilities, such as hospitals, nursing homes, and student dormitories;
2. All investments in home equipment or improvement loans;
3. All investments in mortgage-backed and mortgage-related securities (whether of the pay-through bond or asset participation type);
4. Qualifying assets held by any subsidiaries of a thrift; and
5. All investments qualifying as legal, short-term liquidity pursuant to the Board's regulations under

the Federal Home Loan Bank Act.

SPECIAL TREATMENT FOR SAVINGS BANKS

As noted earlier, the current "60%" test in S. 2181 would exclude a majority of savings banks from qualifying status. Like savings and loan institutions, savings banks have historically allocated a very high percent of their loans to real estate, but have had a lower ratio of residential loans to assets due to a higher commitment to securities and liquid assets. At the same time, savings banks' portfolio investment in residential mortgages and mortgage-backed securities has far exceeded that of commercial banks.

Given these facts, we believe S. 2181's housing based test should be modified to allow a transitional period for savings banks originally chartered as such to meet the "60%" test. Specifically, we recommend amending the bill to initially permit such savings banks to qualify at a lower asset ratio such as 40% or 50%, gradually phasing up to 60% during an appropriate period of time.

QUALIFYING AVERAGING PERIOD

Finally, with respect to the S. 2181 asset test mandate for qualifying on a two out of three year averaging basis, we agree that an averaging concept is necessary. We are not sure whether it ought to be based on two-out-of-three years averaging or whether it ought to be more like three-out-of-five years. We would be happy to work with the Committee to devise an appropriate averaging formula. Institutions must have the flexibility to cope with volatile economic conditions and a rapidly changing marketplace without the penalty of disruptive changes to service corporations and holding company authorities.

SUGGESTED CHANGES TO S. 2134 QUALIFYING ASSETS TEST

We are concerned that S. 2134 strips a unitary S&L holding company of its diversification options and reduces its authority to that granted a multiple S&L holding company if its thrift subsidiary fails to meet a two-pronged qualifying asset test which is far more restrictive than that established by the Garn-St Germain Act or S. 2181.

First, in all cases, a thrift must have 60% of its assets devoted to "residential mortgages and related investments," on average, during the year. Related investments include residential mortgage-backed securities, retail mobile home loans, home improvement loans, loans to finance the construction of residential properties, and investments in a service corporation in proportion to that corporation's qualifying assets. The explanation accompanying the bill indicates that a "residential mortgage" is associated with only one-to-four family home loans.

In addition, regardless of its thrift subsidiary's portfolio composition, a unitary holding company would be limited to multiple holding company status if the services or products of its subsidiary thrift are offered to or marketed through the holding company or its subsidiaries, or the products or services of the holding company and its subsidiary are offered to or marketed through the insured thrift. Our reservations concerning this provision are discussed in some detail later in this statement.

In the Board's view, S. 2134's "60%" asset test goes well beyond establishing what we would consider to be a reasonable commitment to home finance, and could virtually shut off thrifts' access to the predominant unitary form of ownership. In sharp contrast to current law, a unitary's thrift subsidiary could not include in its qualifying "basket" crucial items such as liquidity investments in cash and U.S. obligations, property acquired through the liquidation of defaulted residential mortgage loans, or property used by the association in the conduct of its business. To an even greater degree than S. 2181, S. 2134 would severely undermine a thrift's ability to manage liquidity effectively and make investments closely related to its home finance functions. In effect, S. 2134 would create a kind of straitjacket which would greatly deter affiliations between thrifts and unitary holding companies which could provide sorely needed capital infusions and supplementary income to an industry which lost one quarter of its entire net worth in 1981 and 1982.

Given these problems, we recommend that the "60%" asset composition test embodied in S. 2134 be modified along the same lines suggested earlier with regard to S. 2181.

SERVICE CORPORATION AUTHORITY OF QUALIFIED AND NON-QUALIFIED THRIFTS UNDER S. 2181

Under Section 110 of S. 2181, independent qualified federal thrifts would have the same service corporation authority permitted under the Home Owner's Loan Act (HOLA).

Section 110 of S. 2181 would allow non-qualifying federal thrifts to invest up to 3% of assets in grandfathered HOLA service corporations, 5% of assets in a clerical "depository institutions service corporation," and, if mutual, 3% of assets in a HOLA-type "mutual thrift service corporation" which would have the investment flexibility provided by Bank Board regulations as of July 1, 1983.

While the intent of Section 110 is somewhat unclear, it literally appears to provide that all independent state thrifts, whether qualifying or non-qualifying, would retain all the subsidiary powers allowed under state law. In addition to those powers, non-qualifying state-chartered thrifts would also be allowed to invest in a depository institution service corporation. However, state authority broader than the Bank Holding Company Act "laundry list" would be lost if an institution became part of a multiple savings and loan holding company or a bank holding company or was not a qualified thrift lender and was subsequently acquired by a unitary savings and loan holding company.

Our primary concern with S. 2181's service corporation changes is that it allows significant evasion of the bill's general intent to affirm and reinforce the differences between thrifts and banks. S. 2181 leaves intact the authority of all state thrifts and state and national banks to invest in a broad array of operating-type and other subsidiaries. By contrast, non-qualifying federal stock thrifts are limited to investment in a service corporation which can only perform clerical functions for other depositories, and non-qualifying mutual federal thrifts have their service corporation authority frozen as of July 1, 1983. Non-qualifying federal thrifts are therefore left with far less structural flexibility than state thrifts or banks. The problem is especially acute for federal mutuals, which cannot, as a practical matter, convert overnight to take advantage of the broader affiliate powers allowed by S. 2181 for multiple savings and loan holding companies and unitaries owning non-qualified thrift lenders. This inconsistent treatment would unhinge the dual chartering system by precipitating a flight to convert from federal to state charter. In effect, the bill would create a massive loophole by allowing bank-like state-chartered thrifts outside a holding company to preserve a galaxy of subsidiary options while still maintaining access to all the benefits of FSLIC insurance and Bank System advances.

Given these considerations, we must oppose the proposed inconsistent treatment of service corporation authority for non-qualifying state and federal thrifts. We cannot concur, as some have suggested, that the inherent contradictions and unfairness can be addressed through a "mutual holding company" concept. We believe this concept contains unresolved complexities and cannot support it at this time. In addition, this concept does nothing to resolve the "loophole" effect undermining rational bank-thrift regulation.

In our view, the more effective and equitable means of drawing an additional boundary between qualified and non-qualified thrifts involves access to the benefits of the Federal Home Loan Bank System. That System was designed exclusively to support and nurture the liquidity needs of home lending institutions. And I believe that the Board's use of discretion regarding the Federal Home Loan Banks' advances policy -- by denying advances other than for liquidity purposes to thrifts which have abandoned their housing commitment -- would strongly discourage such action. Because state and federal members would be subject to the same regulatory policy, both types of thrift would receive equal incentives to maintain their home finance character. And this approach would avoid creating perverse incentives to switch from federal to state charter.

As I mentioned earlier, the Board strongly supports the notion that any restructuring legislation must enhance the value of the thrift charter and facilitate profitable use of the supplementary asset powers granted by the Garn-St Germain Act.

Therefore, in conjunction with establishing any legislative agenda of reform which reinforces the bank-thrift distinction, we also believe it is crucial to increase the basic service corporation investment authority of qualified federal thrifts under the Home Owners' Loan Act. I am concerned that the current three percent figure is overly confining to allow qualified lenders to maximize profits through subsidiary operations, especially in view of developing liberalization of service corporation authorities in various states for state-chartered thrifts.

BANK HOLDING COMPANIES AND SAVINGS AND LOAN HOLDING COMPANY POWERS

Under S. 2181, unitary thrift holding companies that own a qualified thrift lender would have all the investment powers allowed unitary companies under current law. All other savings and holding loan companies and all bank holding companies would receive an identical "laundry list" of permissible activities, including opportunities for (1) owning both banks and thrifts, (2) investing in security affiliates which could underwrite U.S. and state obligations, mortgage-backed securities, and mutual fund shares, (3) engaging in insurance brokerage and underwriting, and activities determined by the Federal Reserve to be of a financial nature, and (4) engaging in limited real estate investment and development activity. No bank or S&L holding company (other than a qualified thrift lender-type unitary holding company) could devote more than 5% of its "primary capital" to real estate investment and development activity, and would be barred altogether from construction activities. The Federal Reserve Board would have primary authority to define permissible activities for any savings and loan holding company other than a unitary with a qualified thrift lender. The Bank Board could impose regulatory limits on most activities consistent with safety and soundness and certain other factors, but would have no discretion to alter rules determined by the Federal Reserve Board regarding activities of securities affiliates.

We have no objection in principle with the S. 2181 approach of "equalizing" the powers of savings and loan holding companies owning non-qualifying thrifts and bank holding companies. But we are strongly opposed to provisions which would deprive a multiple savings and loan holding company with all qualified thrifts of critical sources of capital and income.

We find the S. 2181 limits especially troubling as they affect real estate activity of qualified thrift lenders and multiple savings and loan holding companies owning only qualified thrift lenders. Under current law, there are no comparable restrictions on the ability of multiple savings and loan holding companies to engage in real estate acquisition and development. S. 2181 would indiscriminately limit real estate investment and development for all multiple S&L holding companies -- even those owning only qualified thrift lenders -- to an economically insignificant level. In addition, federal qualified lenders within a multiple holding company or bank holding company would lose their current authority to carry out those activities through service corporations, if the parent holding company had already reached its 5% of capital cap. In fact, any service corporation authority of a qualified federal thrift which conflicted with the bank holding company "laundry list" would be lost if that thrift were acquired by a bank holding company or multiple savings and loan holding company.

We oppose this aspect of S. 2181 because it would undermine the current vital contribution of service corporation and multiple holding company diversification to the overall health of qualified federal thrifts. We strongly recommend revising this aspect of the bill to preserve the current real estate-related authority for all multiple S&L holding companies owning only qualified thrift depositories, and to preserve, in all such cases, the service corporation authority granted under the HOLA to qualified federal thrifts.

We also find no basis for establishing the Federal Reserve Board as arbiter of permissible activities rules for multiple savings and loan holding companies whose insured depositories are all qualified thrift lenders. In my view, the viability of the thrift industry can be ensured only if the full regulatory integrity of the Federal Home Loan Bank Board is preserved. The Garn-St Germain Act of 1982 reaffirmed the industry's need for a separate regulatory structure, and any dilution of the Bank Board's authority could impede its effectiveness in aiding qualified thrifts to recapitalize and survive as effective competitors in housing finance. Given the Bank Board's long-standing expertise in regulating thrift holding companies, and the goal of providing consistent distinctions in the powers of companies owning banks and qualified thrift lenders, it makes no sense to divest the Bank Board's authority over these traditional home finance activities in favor of a commercial bank regulator.

AFFILIATE TRANSACTION LIMITS

Under S. 2181, depository institution subsidiaries of bank holding companies and savings and loan holding companies would be subject to identical affiliate transaction limits when conducting insurance, real estate brokerage and securities activities. These rules, included in Sections 23A and proposed Section 23B of the Federal Reserve Act, would generally liberalize the extremely restrictive provisions now operative for savings and loan holding companies while still providing safeguards against abuse. We believe these changes are appropriate. However, we are concerned that the statutory language does not afford the Bank Board clearly defined, exclusive authority to interpret or modify the rules in the case of multiple holding companies owning only qualified thrift lenders. We believe a modification along these lines is essential in view of the Board's historic expertise in regulating savings and loan holding companies and in view of the major differences in portfolio concentration of bank and thrift holding companies, particularly in the real estate area.

THE INVESTMENT BANKING ISSUE

Although the Board strongly supports preserving the current holding company diversification options for qualified thrifts, we have fundamental reservations about one type of affiliation. Neither S. 2131 nor S. 2134 would prohibit explicitly combinations of securities firms which underwrite or "make markets" in corporate securities with qualified thrifts and any number of "consumer banks" specializing in consumer credit and residential loans.

We seriously question whether it is appropriate for such underwriting firms to affiliate in any manner with insured depository institutions, whether banks or thrifts. I am convinced that affiliations of thrifts with such securities firms present substantial concerns of potentially harmful conflicts of interest and undue risk, which in turn have profound implications for the safety and soundness of the financial system as a whole and the integrity of the federal deposit insurance system. We are also convinced that allowing such firms to affiliate with insured thrifts would effectively permit them to usurp the insurance benefit for investment products which it was never Congress' intent to protect. Although the financial services area is undergoing great change, we believe that the Congress must provide safeguards to prevent the undermining of thrifts' primary Congressional mandate -- to provide credit for housing -- under the guise of financial services innovation. Given the extremely serious implications of widespread combinations of thrifts with such securities underwriters, I believe that any legislative reform proposal should expressly bar such transactions.

S. 2134 RESTRICTIONS ON CROSS-MARKETING OPERATIONS OF SAVINGS AND LOAN HOLDING COMPANIES

We are generally supportive of provisions in S. 2134 designed to preclude diversification within unitary savings and loan holding companies where any cross-marketing of services or products between the holding company and its thrift subsidiary occurs. However, we believe some narrowing in focus may be appropriate to target specific abuses while preserving the benefits of customary and sound cross-marketing efforts.

The explanation accompanying the bill indicates a concern that the additional ban is necessary to prevent securities firms from setting up a nationwide network for marketing their own products with the full insurance of the FSLIC fund. The section-by-section analysis accompanying the bill restates this concern in broader terms as preventing integration of holding company and thrift services in a manner that would be "inconsistent with the separation of banking and commerce."

The Bank Board fully shares Senator Proxmire's concerns about the role and risk to deposit insurance funds posed by securities underwriters effectively usurping federal insurance for all manner of investment products.

Despite our concerns regarding securities underwriters owning thrifts, however, we are troubled by S. 2134's sweeping effects on legitimate activities of other types of unitary firms based on the stated need to preserve a separation of banking and commerce. Under the sweeping language of the bill, a unitary holding company would forfeit its unrestricted authority in a variety of situations where cross-selling of credit or managerial services is an efficient means of increasing financial strength and profits related to traditional thrift activities throughout the holding company structure. For example, the bill would prohibit a thrift from advertising or marketing in any way services such as credit cards, or life or title insurance offered by its own service corporations or by a holding company subsidiary.

In the vast majority of cases, we can find no sound policy justification for imposing a prohibition on cross-selling of all products or services as a condition of diversified unitary savings and loan holding company ownership. Thrifts' ability to affiliate with diversified holding companies has existed throughout the history of the Federal Home Loan Bank System, and was expressly reaffirmed as appropriate by the Garn-St Germain Act. Additionally, we have seen no evidence of abuse or safety and soundness problems related to such affiliations.

Any sweeping restriction on unitary savings and loan holding company authorities premised on the need to separate "banking" and commerce is not justified because thrifts are not banks. The unique statutory mandate of federal thrifts to provide home finance credit, and the overwhelming portfolio orientation of thrift institutions toward home finance, have not changed since the passage of the Garn Act. Thus, we can see no basis for rolling back Congress' decision to retain the unitary holding company's authority subject to the subsidiary's genuine housing finance commitment.

Numerous statutory and regulatory safeguards also exist which address potential concerns of safety and soundness and unfair competition which might arise through thrift affiliation with non-thrift firms in a diversified unitary structure. Thus, the Savings and Loan Holding Company Amendments of 1967 impose a strict prior approval requirement where an insured institution plans to engage in a purchase, sale or lease of assets with an affiliate, or to contract for management, advertising, or any other services from a holding company affiliate if the aggregate consideration for such agreements exceeds the lesser of $100,000 or 0.1% of the institution's total assets. In addition, the Home Owners' Loan Act expressly bars a federal association from varying the fee for a service, or extending credit to a customer, on condition that the customer obtain additional services from a service corporation or other affiliate. Recent amendments to the Real Estate Settlement Procedures Act also prevent a savings and loan from recommending that a customer use its service corporation's settlement services unless the relationship is fully disclosed to the customer at or prior to the time of the referral.

These considerations once again emphasize the need for reforms narrowly focused on the concerns raised by thrift affiliation with underwriters and market makers of corporate securities. I would urge the Committee to target the "thrift independence" test to what I consider to be a fundamental component of any financial services legislation: an explicit ban on thrift affiliations with securities underwriters and market makers.

We would be pleased to work with the Committee to draft appropriate revisions in this regard.

STATE INSTITUTIONAL RESTRICTIONS UNDER S. 2134

In response to increasing deregulation of state bank and thrift asset powers, S. 2134 prohibits such institutions from commencing, after June 3, 1983, any activities unless they were authorized explicitly under state law by a statute adopted (or interpretation promulgated thereunder) prior to January 1, 1983. This section attempts to strike a balance between the need to preserve the benefits of competition and innovation provided by the dual banking system, and the perceived need to halt state deregulatory initiatives which provide indirect means to circumvent the activity limits provided in the Bank Holding Company Act.

The Bank Board is sympathetic to the concerns reflected in the bill which would place limits on the activities of state-chartered thrifts and banks. As deregulation proceeds at a dizzying pace at the state level, the federal insurance funds are experiencing strains never foreseen in previous decades. I am a staunch advocate of states' rights and the dual system, but there is no doubt that the risks of deregulation, and the need to protect the safety and soundness of the federal deposit insurance funds, are on a collision course.

While we are sympathetic to the apparent intent of the S. 2134 restriction to address this problem, we believe certain changes are vital to make it workable. In our view, federal action to limit the asset and liability powers of state chartered thrift institutions must be fashioned to provide the federal deposit insurance agencies with sufficient discretion to ensure safe and sound use of any new asset authorities. A concept which we believe has considerable merit is to modify the S. 2134 concept by: (1) granting the Bank Board plenary and exclusive authority to waive restrictions where the use of new asset or liability power is consistent with a sound and profitable home lending commitment, and (2) providing the federal insurance agencies broad discretion to require that institutions undertaking highly risky activities make separate and additional contributions to the system, commensurate with the additional risks the new activities may be deemed to impose on the FSLIC.

We believe that implementing such a concept should be of the highest legislative priority. As the operating head of the FSLIC, the Bank Board has received from Congress an overriding mandate to preserve thrifts' safety and soundness, to conserve and protect the resources of the insurance fund, and to ensure public confidence in our FSLIC-insured institutions. Action to reconcile the current insurance structure with the escalating strains of deregulation is crucial to the continued viability of the FSLIC fund. We would be pleased to work with the Committee on developing legislation to address these concerns, and urge you to give this fundamental issue your immediate attention.

CONSUMER BANKS

We are greatly troubled by the provisions in the Garn bill which would create a special category of "consumer banks" which could be federally insured; and which could be owned by non-financial companies with no restrictions on their activities, which would be totally outside both the Bank Holding Company and the Savings and Loan Holding Company Acts. Under the bill, these "consumer banks" are banks which have no more than 5% of their assets in commercial loans; the other 95% can be a mixture of residential mortgages, consumer credit, mortgage-backed securities, investments in U.S. and State obligations, and in certain types of short-term commercial type loans such as CDs, sales of Federal funds, bankers acceptance and broker call loans.

Because the "consumer banks" would have a great degree of investment flexibility regarding both commercial and residential loans, we seriously question whether it is appropriate to exempt ownership of these entities from holding company restrictions. In effect, carving out this exception creates a gigantic loophole and frees consumer banks from regulatory safeguards imposed on thrifts and banks, while allowing such banks and their corporate parents many benefits of a true thrift or bank charter, such as access to deposit insurance and the Federal Reserve payments system. Because we see no sound policy basis for such provisions, we strongly urge their deletion from the proposed legislation.

ANTI-TYING PROVISION

The Garn-St Germain Act imposed a number of anti-tying restrictions on thrifts generally parallel to those found in the Bank Holding Act. In general, these limits are designed to prohibit banks and thrifts from coercing customers to obtain additional services or credit in order to receive a loan or other service. While the current law allows an injured party to sue the association to enjoin such practices, S. 2181 would allow a trade association to bring suits on behalf of their members to obtain injunctive relief.

Absent any evidence of abuse in this regard, we find no justification for this amendment. Our conviction that this amendment is unnecessary is reinforced by the strong opposition expressed by the U.S. League of Savings Institutions, which represents some 3500 savings institution members and is the largest trade association in the industry.

INTERSTATE BANKING

The reforms incorporated in Title X of S. 2181 would impose on national banks and federal thrifts identical interstate branch expansion limits linked to state law, including state agreements based on reciprocity and regional compacts. The bill would also allow interstate acquisitions by bank holding companies and multiple savings and loan holding companies, as permitted under state law. These provisions would sunset in five years.

The Board is opposed to any changes in current law governing interstate branching by federal thrifts, or the location of multiple savings and loan holding company thrift subsidiaries.

We are gravely troubled by the implications of these changes for the integrity of the FSLIC fund and see no sound policy basis for sharply reducing the statutory discretion long accorded federal thrifts regarding interstate branching.

In effect, except to the extent state law permitted interstate branching, the bill would in many cases prevent the Bank Board from authorizing interstate supervisory branching, mergers and reorganizations involving federal thrifts, even where this would represent the least costly solution for the insurance fund. This result is totally inconsistent with the Bank Board's goals of preserving the value of the thrift charter and maintaining the solvency of the FSLIC.

There is no evidence that the Bank Board has used its discretion regarding interstate mergers in this area in any but the most circumspect and prudent manner. Thus, the Board has long precluded interstate branching except in supervisory situations where such expansion was a component of a merger designed to minimize FSLIC outlays and avoid costly liquidations.

Any legislation which would deprive the Board of this vital flexibility in husbanding the resources of the fund would have grave consequences. The fund is already under enormous stress due to the thrift earnings crisis of the 1980-82 period, and absent strong remedial action, we would foresee additional strains resulting from asset problems related to deregulation and unlimited access to brokered money.

As I said earlier, the current FSLIC reserves-to-deposits ratio is approaching a historic low point. Since December 31, 1980, almost all income received by the FSLIC has been expended to solve problem cases, so that the fund is approximately the same size as it was three years ago. But at the same time, total deposits have increased from $501 billion to $671 billion on December 31, 1983.

For 1984, we project that a substantial part of the $6.3 billion FSLIC fund will have to be spent to cover liquidations and supervisory mergers. This projection does not include additional cases which only recently have come to light. These additional cases involve FSLIC-insured institutions in which more than fifty percent of their deposits have been obtained through deposit brokers and present very significant asset value problems as well.

And S. 2181 would vastly reduce our options, not only by directly limiting federal thrift interstate branching in supervisory cases, but by granting bank holding companies more liberal interstate bank acquisition rights and allowing them to acquire thrifts in nonsupervisory cases. This liberalized authority, in conjunction with interstate branching rights for national banks, could reduce or eliminate any incentive for banks and bank holding companies to obtain interstate rights by acquiring a weakened thrift and reducing the costs to the FSLIC.

The Garn-St Germain Act of 1982 expressly recognized that allowing bank holding companies to acquire thrifts was appropriate in view of the severely weakened state of the industry and the resulting pressures on the FSLIC fund. Increasing the universe of institutions potentially able to acquire a troubled thrift injects greater competition in the assisted acquisition bidding process, reducing FSLIC assistance outlays, and lessening the likelihood of liquidations. To date, the FSLIC's ability to authorize such acquisitions has resulted in substantial savings to the fund.

In our view, the provisions of Title X would sharply diminish the pool of bidders for weakened thrifts, and result in rising expenses to stave off failures or carry out liquidations which the FSLIC might otherwise have avoided. In view of this very adverse effect on the FSLIC, we are opposed to any changes in geographic controls on expansion by banks and bank holding companies.

PAYMENT OF INTEREST ON RESERVES

The Board continues to support the payment of interest by the Federal Reserve on reserves held by depository institutions against transaction accounts, as provided for in Title IV of S. 2181. Presently, non-regulated financial intermediaries, such as money market funds, are not subject to reserve requirements and, therefore, are able to earn more on their deposit base. Affording the same advantage to banks and thrifts will enable them to offset their increased cost of funds and to compete more effectively with non-regulated entities. Benefits should also flow to the customers of the banks and thrifts in the form of higher rates on deposits or lower rates on loans.

INTEREST ON DEMAND DEPOSITS

The Board testified in October 1983 in favor of removing the prohibition against the payment of interest on demand deposits, as provided for in Title VIII of S. 2181. The Board continues to support that proposal as a vital step in the deregulation of accounts offered by financial institutions. Notwithstanding the increased interest cost to institutions, interest-bearing checking accounts will benefit consumers and small businesses and will foster competition. In view of these likely benefits, we see no basis for the minimum six-month delayed effective date proposed for removing the current ban, nor for the proposed extension of authority to the Depository Institutions Deregulation Committee to delay decontrol for an additional six months. We strongly urge the Committee to provide for immediate decontrol of demand accounts.

Under present law, federal thrift associations may only offer demand deposits to business entities with which they have a commercial lending relationship or which use the demand account solely to accept payments to it by non-business customers of the association. Expanding this authority would increase the flow of funds to federal associations and enable them to establish better working relationships with local housing-related businesses.

I would also like to state the Board's strong objection to the claims of some that affording thrifts full demand account authority would immediately erase any distinctions between commercial banks and thrifts. Depository institutions, whether banks or thrifts, are by definition, engaged in deposit gathering -- whether it is in the form of savings deposits or demand deposits. In my opinion, the authority to access funds in a particular manner, is not, and should not be, the determinant of "parity." Rather, the parity test ought to derive from how the funds are used once acquired by an institution.

As I have stated earlier in my testimony, any objective look at the comparative authority of commercial banks and thrifts, and the enormous disparity in their actual portfolio orientation, demonstrates forcefully that there simply is no parity between the investment activities of the two types of institutions.

We believe that in the final analysis the so-called "parity" argument is, for all practical purposes, irrelevant since the practical consequences of the distinctions in asset authorities between banks and federal thrifts dictate different missions for both types of depositories.

CONCLUSION

As the regulator of federal thrifts, we at the Bank Board are acutely aware that the unique thrift regulatory structure continues to exist -- and can only exist in the future -- in order to support the housing finance function. We believe that S. 2181 recognizes this underlying foundation of the Federal Home Loan Bank System's regulatory framework, and provides a constructive basis for a dialogue on how further reform should proceed. We do have strong reservations about those portions of the bill which would deprive qualified thrifts of structural flexibility desperately needed to support their housing finance mission, and which attempt to "equalize" the powers of commercial bank holding companies and multiple savings and loan holding companies owning exclusively qualified thrift lenders.

The changes we have recommended are offered to the Committee with the sincere hope that they will be understood as reflecting our commitment to helping thrift institutions to renew their strength, while at the same time contributing to the time honored concepts of safety and soundness -- dual goals of this Bank Board. We look forward to working with the Committee to reach these goals. I will be happy to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. Gray.
Mr. Callahan.

STATEMENT OF EDGAR F. CALLAHAN, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Mr. Chairman, members of the Committee, I am pleased to be here today to testify on behalf of the National Credit Union Administration on S. 2181, the Financial Services Competitive Equity Act, and S. 2134, the Depository Institutions Holding Company Act Amendments of 1983.

I recognize that the efforts of the Committee have been structured towards a very comprehensive and far reaching examination of today's financial marketplace. Credit unions are and will continue to be very vital components of this marketplace. From a credit union perspective, the legislation under consideration today is quite revealing. What I find most revealing is that, in the midst of such a far reaching reexamination and reorganization of financial powers and financial boundaries, credit unions are requesting virtually no changes. While numerous modifications are under consideration in most of the financial system, credit union operations remain basically sound and appropriate. In testimony here a year ago, I indicated that few, if any, changes should be made to the existing credit union operational and regulatory environment. I continue to believe so, and I am most pleased that the legislative proposals before the Committee support this conclusion.

For the record, Mr. Chairman, I would like to apprise the Committee of our latest figures on credit union activities. For in the final analysis, it is such results which reveal the adequacy of credit union operations in a significantly more competitive environment. During 1983, credit unions grew by over 20%. Lending improved substantially with an increase of 17.8%.

Due to expanded chartering activity, potential members grew by 8.4 million. The number of involuntary liquidations was only 50 in 1983, compared with 160 in 1982, which reflects a much improved economy. In short, the financial condition of our nation's credit unions is very good.

S. 2181

Contained in S. 2181 are a limited number of credit union amendments, most of which are technical or corrective in nature. I would like to comment briefly on them prior to addressing the capitalization of the NCUA Insurance Fund. NCUA fully endorses the following amendments contained in Title II:

A. **SECOND MORTGAGE LOANS (201)** - This amendment would give the NCUA Board flexibility in allowing second mortgages to be written for a period exceeding 15 years. This would, for instance, allow a credit union to offer variable rate second mortgages that could allow for extension of the maturity of the loan rather than require higher monthly payments or a balloon payment.

B. **FAITHFUL PERFORMANCE (203)** - The present statutory bonding provision requires credit unions to secure a "faithful performance" bond for employees and officers. Recent case law has held this to be a different standard from similar bond requirements of other financial institutions. The bond requirement has been interpreted as covering acts approximating simple negligence. Insurance losses could exceed premiums in the future and ultimately the bond may become prohibitively expensive. The amendment would provide NCUA with clear authority to define the risk that credit unions must insure against through their fidelity bonds.

C. **MEMBERSHIP OFFICER (204)** - A technical amendment to correct an error in the Depository Institutions Act of 1982 which will again allow membership officers to be selected from the credit union's membership rather than restricting the job to a member of the board of directors.

D. **POWERS OF THE BOARD OF DIRECTORS (205)** - This amendment is technical to conform with the faithful performance amendment (203). It would authorize credit unions to "provide adequate fidelity coverage for officers and employees having custody of or handling funds according to regulations issued by the Board." With respect to 205(2), (5), and (6), see our comments on Membership Shares (202).

E. **NONPARTICIPATION IN THE CREDIT UNION (206)** - This is a technical amendment to clarify that the present options for expelling a member are alternative methods.

F. **CHANGE IN INSURANCE STATUS (207)** - This amendment would simplify the process of a state chartered credit union converting from Federal insurance to insurance offered by some other corporation authorized and duly licensed to insure member accounts. Approval would be required by a majority of those members who choose to vote. This conforms to language in the Garn-St Germain Act regarding charter conversion.

With respect to Membership Shares (202), the agency is not aware of any need to establish a classification of shares which would be uninsured. Nevertheless, should the Committee decide to adopt such a provision, we would have no objection.

Section 402 would require the payment of interest by the Federal Reserve on reserves held against money market accounts. We certainly support this provision.

Title VI would include credit unions under the provisions of the Fair Deposit Availability Act of 1983. At this point in time, Mr. Chairman, I see no reason to include credit unions under these requirements. We recently declined participation in the preparation of a joint policy statement from the other Federal regulators to their institutions on the subject of delayed funds availability.

Section 704 would permit the credit union loan rate ceiling to be established by each credit union's board of directors. We have testified on many previous occasions in support of this amendment and continue to do so today.

Share Insurance Fund Capitalization - S. 2121

From an NCUA perspective, Mr. Chairman, there were two matters which I considered of paramount importance in preparing the NCUA to meet the credit union future. These were: (1) the full funding of the Central Liquidity Facility (CLF) and (2) the completion of the capitalization of the Share Insurance Fund (NCUSIF). I am very pleased to report that on February 1, 1984, over $200 million was tranferred to the CLF by credit unions joining this facility. As a result, over 90% of all credit unions are now members of the CLF and they represent approximately 95% of all credit union assets. This, of course, secures a very strong credit union liquidity position to meet future demands.

With respect to the Share Insurance Fund capitalization effort, Mr. Chairman, I can only reiterate my personal thanks to you and your Committee for the decisive actions which were recently taken. Because of your leadership role on behalf of this credit union effort at self-help, a potentially disasterous interruption was avoided and the chances for enactment seem better than ever.

S. 2121, the Share Insurance Capitalization proposal, will increase the capitalization of the Fund from $240 million to over $1 billion. This will be accomplished by receiving from insured credit unions a refundable deposit of 1% of insured shares. Shortly after enactment, therefore, the normal operating level of the Fund will rise from .03 of total insured shares to 1.3%. This will finally place the NCUSIF at an approximate level with the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation. This will be accomplished without the use of any government capital as was required in the other funds. I point with great pride to the managers and directors of our nation's credit unions who have collectively reached a decision to overwhelmingly support this legislation. I believe this is one of the best demonstrations of the credit union principle of self-help that could be presented.

As you know, Mr. Chairman, there have been five changes to the original language of S. 2121. These changes are:

1. The title of the bill has been changed to reflect the actions taken by credit unions to capitalize their insurance fund.

2. NCUA's authority to impose a second premium is eliminated.

3. The 1% deposit would also be returned to credit unions in the event that the Fund were transferred from the NCUA.

4. NCUA would be required to report annually to the Congressional Banking Committees on the operating level of the Fund, including the results of an independent audit.

5. All provisions in S. 2121 relating to liquidation payout priority have been deleted.

Before closing, Mr. Chairman, let me again express my thanks and take a moment to mention two final items.

First, the CLF Tax Exemption S. 2120. This technical correction to the enabling CLF statute is long overdue. While the tax costs of the early years of CLF operations were minimal, the 1983 obligations are in excess of $1 million and all efforts to secure an administrative ruling have been exhausted. I don't know if this amendment could be included in the provisions of S. 2121, but every effort must now be made to remove what is becoming an alarming liability for the CLF.

Finally, I wish to remind the Committee of the fact that NCUA's conservatorship authority will expire on October 15, 1985. We have found this regulatory tool to be indispensable in handling certain credit union situtations. In the deregulated financial environment of the '80's, I believe the agency must have this authority on a permanent basis.

I will be glad to answer any questions which you or the Committee members might have.

The **Chairman**. Thank you very much, Mr. Callahan.

Gentlemen, each of you referred in some fashion to the definition of a bank in your written statements and I would appreciate it if you would restate and expand on what you think a bank should be.

Mr. Isaac, would you like to tell us what you think a bank should be?

SIMPLE CONCEPT OF A BANK

Mr. **Isaac**. Mr. Chairman, as I point out in our testimony, our definition of a bank is a new definition. It's a pretty simple concept and I think a pretty effective means to accomplish the public policy goals that we are trying to accomplish.

A bank in our view should be defined as an entity that calls itself a bank. It leads the public to believe it's a bank and that it's a safe place to put funds. This definition would serve to maintain public confidence in the banking system. It would close down the nonbank bank loophole. It would subject banks and thrifts that choose to call themselves banks to the same type of regulatory treatment. Probably as important as anything, it would prevent a recurrence of tragedies like we recently witnessed in the States of Tennessee and Iowa where uninsured banks failed, eliminating the life savings of innocent depositors who placed their funds in institutions that led them to believe that they were banks and that they were safe.

I think this definition really goes a long way toward solving all the problems of trying to bring together a coalition of people behind this legislation. I would encourage the committee to give it every consideration.

The **Chairman**. Well, how would you actually enforce it? Would you pass a law and say that they have got to call themselves a bank if they accept deposits? Is that your definition?

Mr. **Isaac**. No. An institution would be permitted to accept deposits without calling itself a bank. An institution could not call itself a bank without obtaining FDIC insurance. The only way an institution could obtain FDIC insurance is if it both accepts deposits and calls itself a bank.

The **Chairman**. And you exclude the commercial loan authority?

Mr. **Isaac**. I would exclude the commercial loan test for what is a bank. I don't think that's a relevant test. I think the relevant test is whether it's insured by the FDIC.

I sat in my office the other day trying to cope with the definition of a bank and found I couldn't do it in the abstract. Everybody says, well, you've got to start with a definition of a bank. I don't think that's where you start. I think you first have to start with why we care what a bank is. It's because the public cares about what a bank is. The public wants a safe place to put its funds. The public wants to know that there's some place in our economy where funds can be placed and be safe up to a certain amount.

If an industrial bank or other institution calls itself a bank, the public rightfully concludes that it is protected, that it's not going to lose those funds.

It seems to me that we ought not to allow institutions to advertise themselves as banks, as safe havens for funds, and not provide

Federal insurance for those funds. We ought not to allow this deception on the public to continue. A bank in Iowa held itself out as a bank. People placed their life savings in it believing they were safe, and yet the institution was not required to obtain Federal insurance and be regulated like a bank. An institution can be State insured and call itself a bank and it can fail, bankrupting a State insurance fund that doesn't have the resources to stand behind the obligations. The public is hurt, even though they believed that they were dealing with a safe entity.

It seems to me we have to consider why we care what a bank is. We care what a bank is because we want it to operate safely and protect the public's funds.

The CHAIRMAN. Well, if you're looking for a safe haven or a safe place, how about an FSLIC-insured institution? Is that then a bank?

Mr. ISAAC. If I had my preference, I wouldn't have separate FSLIC insured institutions. I would merge the FDIC and the FSLIC together, the Bank Board and the bank regulatory agencies together and regulate banks and thrifts alike. But there is another point of view on that expressed very eloquently by Chairman Gray that says that we want these specialized entities out there; we want to encourage thrifts to engage in housing finance. I'm willing to see those entities sit out there, for the time being at least, with a separate regulatory structure, a separate insurance system and the like.

I would draw a line, though. If thrifts are going to be under a different regulatory and insurance system, then they ought to be specialized in housing finance. They ought to be required to specialize in housing finance and they ought not to pretend like they're banks by calling themselves banks. That is, it's tremendously unfair competitively and it's also unfair to the American public.

The CHAIRMAN. Mr. Gray.

THE ROLE OF THE THRIFT INDUSTRY

Mr. GRAY. Well, I have referred back on many occasions to the more than 50 years' support of the Congress for the Federal Home Loan Bank system which I serve as chief executive officer and the Federal Home Loan Bank Board, and the role of the thrift industry.

In fact, only 2 years ago, Congress in that landmark legislation, the Garn-St Germain legislation, referred in expressing its intent to housing finance institutions, and it referred to their role in the revitalization process of the housing industry.

Thrift institutions are not banks. Banks are not thrifts. And as I have also said before, you can't have your cake and eat it too. If you're a thrift and you aren't interested in making your primary mission housing finance, then you ought to have an opportunity as an institution to become a commercial bank. I suppose in that way I would agree with Mr. Isaac.

But I think the fundamental regulatory framework was reaffirmed as a result of the long study of the Bush task force, in which the entire regulatory and insurance structure of the thrift industry was kept separate. I think that has been something that's been supported, as I said, over these many years by the Congress, and I think the structure has served the industry very well. And I would hope that the Congress would reaffirm that purpose and role, both of the mission of the industry and the role of our regulatory and insurance apparatus—as a separate apparatus.

The CHAIRMAN. Would you agree that thrifts should not call themselves banks? A lot of them do.

Mr. GRAY. You mean savings banks?

The CHAIRMAN. Not just savings banks. There are some other thrift institutions that also tack on banks to their name.

Mr. GRAY. Well, I must in all honesty tell you that some of that occurred before I became Chairman.

The CHAIRMAN. Most of it occurred before you became Chairman.

Mr. GRAY. But I will say that you're not now seeing any institutions calling themselves Federal banks. They are now, as requests are coming in, calling themselves savings banks, and I believe that's exactly what the Congress wanted in the Garn-St Germain Act.

The CHAIRMAN. Mr. Conover, what do you think a bank is?

Mr. CONOVER. Mr. Chairman, I like the definition of a bank that is in the bill. Basically, the bill defines a bank as an institution that is FDIC insured and that accepts demand deposits or the equivalent and makes commercial loans. That is a definition that has been around for a long time and is clarified somewhat by the language in the bill.

In conjunction with that definition, I like the idea of a consumer bank exception so that certain kinds of specialized institutions that do not make commercial loans would not be subject to the Bank Holding Company Act.

The CHAIRMAN. Mr. Callahan, I would assume from your testimony that you just want to be left alone, so you probably don't care what a bank is.

Mr. CALLAHAN. I couldn't have said it better, Mr. Chairman.

The CHAIRMAN. My time is up, so I will turn to Senator Proxmire and get back to the issue of brokered deposits which I was going to bring up when my turn comes around again.

DE NOVO NATIONAL BANK CHARTERS

Senator PROXMIRE. Mr. Conover, it's my understanding that about 1 year ago Dimension Financial Corp. filed 31 applications for de novo national bank charters with the Office of the Comptroller. Those Dimension national banks were proposed to be located in 25 separate States. It's also my understanding that this kind of national chartering procedure would be forbidden, in whole or in part, under the Garn bill, the administration bill, and the bill I've introduced.

My first question to you is: When does your office plan to act on the Dimension bank applications?

Mr. CONOVER. Senator, I think it is inappropriate for me to discuss the Dimension application, just as it would be inappropriate for me to discuss any other applications pending in our office.

As you know, there have been extensive hearings on the Dimension application held in several locations throughout the country, as well as a lengthy comment period. Field investigations have also been conducted. The material is now being reviewed in our Washington office, but I am unable to give you an estimate as to when a decision will be reached.

Senator **Proxmire**. Well, I want to see how much you feel you're free to tell us without being specific about the details of that particular situation.

Let me ask you this. Will your office condition any final approval of bank charters on the Federal Reserve's view of the proposal in its totality? Can you tell me whether or not Dimension is a bank holding company?

Mr. **Conover**. Obviously, that is one of the issues that we are wrestling with, and since we have not reached a decision on that subject, I think it would be inappropriate for me even to hint at my personal views on the subject.

Senator **Proxmire**. Well, aside and apart from that, let me ask you this. Where in the legislative history of the Bank Holding Company Act do you find any evidence that Congress intended to permit the establishment of a nationwide system of limited, chartered, national banks, insured by the FDIC, but not subject to the Bank Holding Company Act?

Mr. **Conover**. As long as we define a bank as an institution which makes commercial loans and accepts demand deposits—and certainly that definition was debated at some length by the Congress in the past—when an institution does not perform one of those functions, it need not fall under the Bank Holding Company Act. That is the same legal premise that has governed other approvals of so-called nonbank banks.

Senator **Proxmire**. Wasn't that legislation intended to be applied to one bank in Massachusetts?

Mr. **Conover**. I am not sure, Senator.

Senator **Proxmire**. This is aside and apart from this particular case. Is the proper role of regulatory officials to administer the law in a cautious manner to preserve congressional intent, or an aggressive manner which would force loopholes and cause new policies?

Mr. **Conover**. I think our proper role is, obviously, to interpret and enforce the law. I suppose underlying your question is another as to whether it is the prerogative of Congress to make decisions on banking structure, including decisions on issues like this one. The answer is, obviously, that it is. You have before you a bill that will deal with the so-called loophole question while maintaining the consumer-bank option, although it is conceivable that the consumer-bank option may not end up in the final version of the bill. I have been hoping for some time that we will get a congressional decision on this issue.

Senator **Proxmire**. Well, we're all anxious to do that. That's why we're holding hearings today. We're working on it and hoping to do it as soon as we can.

Will your office extend its nonbank moratorium beyond March 31?

Mr. **Conover**. No, sir. I see no reason to do so. The moratorium has been in effect for approximately 1 year. Since it only applies to the chartering of new national banks, it is basically ineffective as a way of limiting others who want to get into the nonbank banking business. My lawyers tell me there are at least four or five other ways to accomplish this, including buying a bank and stripping it of its commercial-loan portfolio. Such an acquisition would be subject to the change in the Bank Control Act, but we would be powerless to stop it.

Just because the moratorium ends on March 31 does not mean there will be a flood of new nonbank banks chartered on April 1. In fact, only two applications have been filed since the moratorium began. Those two applications are now in-house, but I have no idea how they will be decided.

All in all, I think the end of the moratorium is really a nonevent.

Senator PROXMIRE. Mr. Gray, during the nomination hearings on Mary Grigsby, I expressed my concern about the wisdom of using the funds of an insured savings and loan association to finance possible corporate takeovers.

Does the Bank Board have enough authority to prevent this from happening; and, if so, when will it change its regulations?

Mr. GRAY. I believe that we have sufficient authority to do that, although in all honesty I would want to confer with counsel to make absolutely sure that is correct.

Senator PROXMIRE. Well, if you need any authority we'd like to have that submitted promptly so we can consider whether or not to put it in the bill.

Mr. GRAY. We will.

Senator PROXMIRE. Mr. Isaac, if Congress can't agree on a comprehensive bank-deregulation bill this year, do you still support the loophole-closing bill you recommended last year?

Mr. ISAAC. As a last resort if Congress can't do anything else?

Senator PROXMIRE. That's right. If we have nothing else this year.

Mr. ISAAC. Calling for divestiture by everybody that doesn't conform?

Senator PROXMIRE. That's right.

Mr. ISAAC. Yes.

Senator PROXMIRE. Thank you.

REACTION TO THE 3-YEAR PHASE-IN

Mr. Callahan, it's been suggested that the credit union share insurance fund recapitalization be phased in over 3 years. What's your reaction to the 3-year phase-in?

Mr. CALLAHAN. Our analysis, Senator, would be that that would be more costly for credit unions than to have them immediately place deposits and give us an opportunity to live off the proceeds of the fund and return to them principal and dividends. It's been my position all along that we will accept all ideas from people in the credit union movement and that ultimately the bill as it's now proposed would give us the flexibility to take whichever way is in the best interest of the credit unions. And it would be my intent to do just that, to take the least costly approach to credit unions, which currently I believe is to have it capitalized all at once.

Senator PROXMIRE. What's your intent now as to how quickly you would move if you were to be given authority?

Mr. CALLAHAN. Well, based on some projections that this legislation could move rapidly, I see no reason why this couldn't be implemented the first of the year which is the normal time for paying insurance premiums.

Senator PROXMIRE. Mr. Isaac and Mr. Gray, I'd like both of you to answer this one. What's your reaction to the following alternative to your proposed regulation on brokered deposits: first, brokered deposits are limited in their rate of growth in any institution to not more than 20 percent a year; and second, brokers assume 5 percent of the deposit insurance risk?

Mr. ISAAC. The latter is not a bad idea, if we can find some way to do it administratively. I don't know whether 5 percent is the right number or some higher number. I think that the former would probably be unnecessary.

Senator PROXMIRE. Twenty percent?

Mr. ISAAC. The limit on their growth would perhaps be unnecessary if you required the brokers to share in the risk of loss. I think 5 percent is probably too low a number in terms of how much the risk they should share.

When a bank fails, typically the FDIC loses substantially more than 5 percent on the assets involved, so I think it would be unfair to let brokers——

Senator PROXMIRE. So you suggest a higher level?

Mr. ISAAC. Yes.

Senator PROXMIRE. And then you'd say the 20 percent is unnecessary; is that right?

Mr. ISAAC. Probably; I think brokers will use their judgment about where to place the funds to a much greater degree than they do now and it would eliminate most abuses if they have to share in risk of loss. I don't believe you need to make them share in all the risk of loss, just some.

Senator PROXMIRE. Mr. Gray.

Mr. GRAY. Well, I believe that the purpose of Federal deposit insurance, as I understand its history, was to insure deposits at depository institutions in our country because they are instrumentalities of public policy. I think that basic concept ought to continue. This is why I've said that the sale of Federal deposit insurance by nondepository institutions, in my view, is serving as a subterfuge which I have not seen expressed in any way as any intent of Congress. But, on the other hand, the Congress has the prerogative to look very carefully at the Federal deposit insurance system in this emerging deregulated environment, and I would hope that the Congress, if it chooses to do so, would exercise prerogatives of its own.

Senator PROXMIRE. Thank you, Mr. Chairman. My time is up.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. Your next question was going to be my first question.

Mr. Gray, you have stated—I have been reading about it—that you're against brokered deposits.

Mr. GRAY. Well, I believe that the sale of Federal deposit insurance by nondepository institutions does indeed represent a spreading cancer on the Federal deposit insurance system.

I would like to say that fewer than one-fifth of all FSLIC-insured institutions use even a penny of brokered funds today, insured or noninsured. In fact, 94 percent of all brokered funds are concentrated in 10 percent of institutions that have more than 5 percent of their deposits obtained through brokers.

PROBLEMS COMING ON FSLIC'S DOORSTEP

But we find a very high correlation between emerging problems coming on the FSLIC's doorstep and the use of insured, brokered deposits today. Several years ago, problems confronting the FSLIC were relatively much more simple to resolve—these essentially were earnings spread problems which were prompted by the high interest rates of 1981 and 1982. By contrast, today those problems are changing very dramatically and becoming asset problems.

It is possible for an institution to get on the telephone to get by wire transfer any amount of funds that an institution wants, and those funds can be invested before we have any idea of the nature of the risk of such investments. As a result, we are having more and more problems come on the FSLIC's doorstep. It's happening now. About every other day we have examples where institutions are using very excessive amounts of insured, brokered funds. Brokered funds themselves, I would say, are not inherently evil. There are two issues here, though. What does the instant access to and the instant availability of brokered funds produce in terms of instant investment in very risky loans? Second, is that really the purpose of Federal deposit insurance—to take this money, as it is being taken now in too many cases from the nondepository institutions, which themselves are benefiting from an unintended Federal subsidy because they pay none of the costs of regulation which must be borne by depository institutions themselves?

So when you talk about insured, brokered funds, you're really talking about the confluence of a number of issues.

I—and I believe my colleague, Chairman Isaac—are not addressing the use of brokered funds. We are talking about the insured, brokered funds that I believe will have a very adverse impact if the growth of insured, brokered funds is allowed to continue.

In our institutions, let me tell you how dramatic that growth is. On December 31, 1981, there were $3.25 billion in brokered funds in FSLIC-insured institutions. By December 31, 1983, that had increased to nearly $29 billion, an eightfold increase. What we are finding now is that problems are emerging faster than we can keep up with them. We do not have the ability, Senator, to be at the end of every telephone conversation where access to these funds is arranged. And in the case of an institution which has nothing to lose, because the FSLIC always loses, but in their gamble it may have something to gain, the use of brokered funds merely exacerbates our problems: problems of safety and soundness of the institution, and particularly the safety and soundness of the Federal deposit insurance fund.

Senator HECHT. Mr. Gray, you were around in the 1960's in California and you remember all the problems of the 1960's and the savings and loans in California and Nevada and the whole West were in a very difficult situation. I could lay my finger on one point in the brokered funds. Do you see anything on the horizon right now if we don't do anything about brokered funds that we're going to have another catastrophe?

Mr. GRAY. As I stated with respect to this spreading cancer on the deposit insurance system, I think that if the growth were to continue and if the funds were to underwrite not only the risk of funds collected by depository institutions themselves—which they were fashioned to do—but also the huge new and accelerating risks of funds which are marketed by nondepository institutions layered on top of the risk which already must be underwritten, there's no way that the finite resources of the Federal deposit insurance system could possibly be expected to underwrite that kind of risk.

Senator HECHT. Thank you.

Mr. Isaac, you have stated you feel a bank should have the right to underwrite corporate securities. Why do you feel that way?

Mr. ISAAC. Because I don't see any safety and soundness risk in it that can't be protected against through proper measures such as requiring these activities be in separate subsidiaries, that they be separately capitalized and funded, that there be strict limits on intercompany transactions, and that they use different names and logos. I see very little downside risks if the activities are properly structured. I see the potential for enormous public benefits.

We enacted the Glass-Steagall Act in the 1930's in response to the banking crisis. It was an overreaction, a misreaction, to the depression. It was alleged there were abuses which caused the collapse of the banking system in the 1930's due to the affiliation between broker-underwriters and banks.

The facts show that's not true. There were some abuses in corporate underwriting in the 1930's. I suspect there are still some today. There's no evidence that those abuses were more common in bank affiliated firms than in investment banking firms generally. There's clearly no evidence the abuses caused any widespread problems in the banking system. The banking system collapsed in the 1930's because we had unduly restrictive fiscal and monetary policies during the course of a major recession, because we didn't have an adequate regulatory system, and because thousands of banks throughout the country did not have access to the Federal Reserve System.

We have remedied those problems. We have created the SEC to regulate securities activities. We've strengthened our bank regulatory system substantially and our examination system. We have put in place a deposit insurance system to reassure the public and we have the Monetary Control Act of 1980 which made the discount window available to all depository institutions.

GLASS-STEAGALL ACT PROTECTS SECURITIES FIRMS FROM COMPETITION

The major purpose that Glass-Steagall serves right now is to protect securities firms against competition. It's being retained to protect the special interest groups, and I as an American citizen and consumer who wants to have the broadest range of financial services possible at competitive prices, resent that.

Senator HECHT. When the securities people were here I mentioned the 14,500 commercial banks and 90 percent of these were roughly under $100 million in footing and obviously they can't get into this. So what you propose to do, in essence, is just give the major banks these powers. Is that correct?

Mr. Isaac. No. I believe that banks of all sizes will be able to underwrite securities, No. 1. No. 2, I'm not trying to give the banks anything. I'm trying to give the American public something—and that is a stronger, more competitive financial system.

Senator Hecht. Well, what size banks do you think would have these?

Mr. Isaac. Right now we have 1,200 banks in the country offering discount brokerage services at commissions 40 to 60 percent lower than full service brokerage firms are offering. I suspect that when it comes to underwriting that we won't see as many banks involved in it as we see in discount brokerage—I suspect that, I don't have any proof—but I still think that we will see a broad range of banks and other institutions around the country offering these services.

Senator Hecht. Well, there are roughly 1,600 banks that have overseas loans which came to us and the major banks from the IMF—they've come back to Congress to help them on these problems.

Do you feel that if they got into the securities business that they would come back to us to help them on that too?

Mr. Isaac. I can't imagine they would. Particularly if you made some other reforms such as strengthening the deposit insurance system to impose more discipline, I think we'll see a stronger financial system.

I don't know of anything in the securities underwriting area that is inherently unsafe and unsound and bound to cause problems. I don't see the brokerage firms not affiliated with the banks coming to you for handouts—other than protective laws to keep people out of their markets—and I don't know why a bank affiliated investment banking firm would come to you and ask for handouts. If they do, say no.

Senator Hecht. Thank you, Mr. Chairman. My time is up. I'll be back for the second round.

The Chairman. Senator Gorton.

Senator Gorton. Mr. Isaac, a quick followup to Senator Hecht's line of questioning, in your recommendations which would lead to bank underwriting of corporate securities, do you include the corporate equities in that recommendation?

Mr. Isaac. Yes; let me hasten to add one point. While we favor corporate underwriting, I recognize the political pressures against it are very powerful. We're interested in having legislation and if the only way we can get legislation is to trim the bill back a bit and focus it on revenue bond underwriting, as the chairman has done, we're fully supportive of that. Some progress is better than no progress at all.

Senator Gorton. I'd like to follow up on the very interesting set of questions the chairman was just asking of you on the definition of a bank. Your definition certainly has a great deal of clarity and I think appeal on that ground, but I guess you lost me when you got into a slight disagreement with Mr. Gray.

If the purpose is the holding out to the public of a place in which the public's deposits would be secure, what difference does it make whether the deposit is insured by the FDIC or by the FSLIC?

MERGE FSLIC AND FDIC INTO ONE SYSTEM

Mr. **ISAAC**. That's a very good question. What we're trying to do is to balance political factors against other concerns. You're right. If we have FSLIC insurance and FDIC insurance, they're both Federal insurance programs, aren't we really guaranteeing the public in both cases that their deposits are going to be safe? The answer is yes, and the ideal solution, in my judgment, is to dismantle the two separate insurance systems and make one and to not have artificial product barriers.

Senator **GORTON**. But those are separate questions.

Mr. **ISAAC**. Well, they are not because if I were to say we don't want a system of specialized thrift lenders—that we want to let federally insured depository institutions be all things to all people and to find their own niches in the market—then we wouldn't have this inconsistency. We would have a Federal Deposit Insurance Corporation, not a couple of different ones. We wouldn't have a separate bank board system and a Home Loan Bank system and the like. Mr. Gray, speaking on behalf of a number of groups around the country that have a legitimate interest in the housing world and truly believing that that system of specialized lending is desirable and should be continued, wants to maintain a separate regulatory and insurance system for thrifts. I say, fine, I can live with that, as long as those thrifts don't pretend like they're banks, by calling themselves banks.

Senator **GORTON**. But from the depositor's point of view, it doesn't make any difference, does it?

Mr. **ISAAC**. Pardon?

Senator **GORTON**. If the reason that you don't want an organization to entitle itself a bank is because of risk to the depositors, that's taken care of. It doesn't matter to the depositor as long as his deposit is guaranteed, how his money is being used, whether it's being used for housing or something else, does it?

Mr. **ISAAC**. I would agree with you that there is a small intellectual problem in the definition, as you point out, because we are providing Federal insurance for S&L's which presumes safety and, therefore, there's something else out there that doesn't call itself a bank that is also safe. Credit unions also have Federal insurance and are safe.

But what I'm trying to do is to work within that political framework that I take as a given. That is, that we aren't going to merge those insurance funds together and regulate these institutions similarly. I'm trying to reassure the public so that the public knows when it walks into the bank that the bank will have Federal insurance and will have safety.

Now there may be something else that doesn't call itself a bank that's also safe. But we should guarantee the public that when they walk and do business with something that calls itself a bank, it is safe.

Now I just want to make one other point and that is the problem I have with this commercial lending clause.

Senator GORTON. Excuse me. You've answered my question and my next one was to Mr. Conover on precisely that subject.

You stated that you liked the definition in the bill, Mr. Conover. You didn't state any rationale for that.

Isn't Mr. Isaac's definition both cleaner and superior as long as something calls itself a bank it ought to be insured, and if it takes deposits and is insured, isn't that what the public needs? What difference does it make from the public point of view in that bank definition whether or not commercial loans are a part of the business of the institution?

Mr. CONOVER. That is part of the historical definition of a bank, which I think makes more sense than the one Mr. Isaac is proposing. As I said earlier, I would like to see the consumer bank option remain in the bill because I think it is good public policy, provided that people who want to get into that business want to get into it for itself, because it is an attractive business to be in. If there are potential conflicts with either other affiliates within a bank holding company or with activities of securities underwriters, it is in the area of commercial lending, not in the area of consumer lending. To reiterate, I think the definition is fine as it sits, with the consumer bank exception.

Senator GORTON. If you simply follow history, then we won't pass any new laws at all, will we?

Mr. CONOVER. I am just saying I like the definition the way it is. I think there's another problem with Mr. Isaac's definition and that has to do with its impact on the individual States and their right to require or not require Federal deposit insurance for State-chartered banks in their States. Now I think it's unfortunate that some people in the State of Iowa and apparently some people in the State of Nebraska recently lost some money because they had it in some State banks that were uninsured, but surely, if that is the case, then there ought to be clear disclosure in the depository institution that the deposits in that institution are uninsured or perhaps that they are insured by a State insurance fund, and I think that the States ought to make those decisions. The people of Iowa are quite capable of passing a law requiring that all State-chartered banks in the State of Iowa must have Federal deposit insurance, if that's what they want.

Senator GORTON. Mr. Isaac.

Mr. ISAAC. I would make two comments. It is not unfortunate that thousands of people lost money in Iowa and Tennessee in uninsured institutions that call themselves banks—it's almost criminal. I think we have an obligation to shut that loophole down to protect the public.

I don't see any reason why States ought to allow institutions to advertise themselves as banks and deceive the public. I believe it's time for Congress to step in and act on this. I come to this position very reluctantly. I'm surprised to hear the Comptroller arguing for State rights because that's usually our role. The FDIC has always been a very State's rights oriented institution and continues to be, but when the problem gets to the point where people are losing their life savings in institutions that called themselves banks and the reputation of safe banks throughout the country is tarnished, it's time for Congress to assert itself.

As far as the commercial lending thing goes, I don't think the problem lies with commercial lending. I don't think that's the issue per se.

For example, insurance companies take the public's money. They don't call it a deposit but it's very much like a deposit, and they put it out in commercial loans and they seem to do OK. Finance companies around the country take in the public's money and put it out in commercial loans, and they do all right. S&L's take in the public's money and put it out in commercial loans.

The issue is: How are we going to regulate these entities and whether and how are they going to be insured? Not because they are engaged in commercial lending activities, but because they are taking money from the public. If they represent that money is safe by calling themselves a bank, then they ought to be regulated like a bank and insured like a bank. If they don't want to claim they're a bank, then fine, let them operate under some other system.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Gorton.

To get back to the brokered deposits issue, of the institutions failing or failed, how many have had brokered deposits? Do either one of you know?

BEARING OF BROKERED FUNDS ON BANK FAILURES

Mr. ISAAC. Since the beginning of 1982, we have had 90 commercial bank failures and 46 have had substantial brokered funds ranging up as high as 76 percent of their deposits. So it's a little over half of the failed banks the past 2 years have had substantial brokered funds.

The CHAIRMAN. But among those, they've had more than a majority of their deposits in brokered funds?

Mr. ISAAC. Sometimes it's been down in the 1- or 2-percent range, but in many, many cases it's been much higher than that. It has gone as high as 76 percent. We just had one this past weekend where the brokered funds accounted for $97 million out of roughly $150 million. That's becoming more and more common. This problem is becoming very widespread.

The CHAIRMAN. Were they placed by national firms or the so-called hot money firms?

Mr. ISAAC. Both, but more by what we would call in some quarters bucket shops than by the big firms.

The CHAIRMAN. Do you have any idea overall what percent of total deposits were brokered?

Mr. ISAAC. Well, that's one of the problems. The numbers are very slippery and hard to get hold of. But we have approximately $22 billion in the commercial banking industry that we're aware of and I think Chairman Gray just said a minute ago that he has $29 billion at the moment in the S&L industry. Total deposits in the two industries range in excess of $3 trillion. So at the moment it is still a fairly manageable number. The problem is that it's growing so rapidly and if we do some of the things we are trying to do in terms of instilling discipline in the system, we will see a substantial increase in the brokered funds.

For example, if large depositors are going to take losses when banks fail, we're going to have to find a way to address the brokered deposit issue or the entire system is going to become insured. We're deeply concerned about how far the Federal insurance guarantee is spread. We have to address it because we do not want and cannot afford to insure the entire funds flow in the economy. I don't have any problem with people who want to place their money at risk, more power to them; but they're going to have to select a bank on some basis other than the interest rate the bank pays.

Senator Proxmire asked the Comptroller if he felt that it should be the regulators job to interpret statutes and the like. I think it is our job to interpret statutes, but you have really given us an impossible job. You've put us in the middle of a brand new environment with a 50-year-old set of statutes. Liabilities have been deregulated and we're inching toward deregulation on the asset side. The old system will no longer work. I would love nothing better than the Congress to pass a statute dealing with expanded powers by banks and a host of other issues. But if you don't change our insurance system in the process of enacting the further deregulation, we're going to have a catastrophe on our hands.

The CHAIRMAN. You're giving my 9-year-old speech.

Mr. ISAAC. That's exactly right. I couldn't agree more. You're my champion.

The CHAIRMAN. If you look at the situation over and over again, although Congress has complained about the regulators doing things that they did not have legislative authority to do, the reason for that has been the inaction of Congress.

The Depository Institutions Deregulation of 1980 came about finally only because of the court telling the regulators that they did not have the authority to establish NOW accounts and we have normally been forced into it. In this case, we can argue which came first, the chicken or the egg, and I think it's pretty clear. The inaction of Congress over a long period of years has been what has come first and the regulators tried to jump in and fill the gaps in the marketplace and they're slapped down by us and by the courts, when all along I think it's our unwillingness to take action. We're facing the same thing again right now of all those who don't want to do anything this year, just let it ride; it doesn't matter what's going on in the marketplace; it doesn't matter whether the house is burning down, don't call the fire department, just let it burn. As I've said so many times, no matter what the decisions ultimately are, we ought to get off our fannies and make some decisions rather than continuing to play chicken because we don't want to offend some particular group.

Mr. ISAAC. It's hard for me to believe, Mr. Chairman, that any decision Congress could make, other than a moratorium, could be worse than where we are today.

The CHAIRMAN. I agree. In one of our hearings someone said the new laws are hard to digest. I agree. Not nearly as hard as digesting the marketplace without some guidance and some policy set by Congress.

Mr. **Gray**. Mr. Chairman, if I may, on the insured brokered deposits issue, we believe that we do have the authority under the insurance statutes to take the action that was proposed back on January 16. So yes, I would consider that an interpretation of our responsibility under the law. And I can assure you that if we did not believe, and if we were not convinced that we did have the authority under statute to take that action, we would not have done so.

The **Chairman**. Well, I understand your position, although it's always been the position of regulators—before the courts told them they did not—that they had the authority. I'm sure they would not have gone ahead if they didn't think they did.

Mr. Conover, why do you feel the proposed rule is too broad in the brokered deposits?

Mr. **Conover**. I thought you'd never ask.

There are two problems, as I see it, with brokered deposits, and I share these concerns with both Chairman Isaac and Chairman Gray. The first problem is that by using brokered deposits small problem banks can become big problem banks in a hurry. The second is that by using brokers someone can take what would otherwise be an uninsured deposit, $1 million or so, and easily split it up into 10 insured accounts of $100,000 each. When that happens, the total portion of deposits in the system that is insured goes up, as does the potential liability of the insurance funds.

PROPOSED RULE IS A CASE OF REGULATORY OVERKILL

While these concerns are justified, I think the proposed rule is a case of regulatory overkill. We can deal with the problem banks through effective supervisory practices, consisting of three elements. The first is reporting. We have recently begun to get information on the use of brokered deposits in the banking system, and we will get additional information beginning in the March 31 call report.

The second element is examination. Our examiners are certainly focusing their attention on brokered deposits in conducting examinations.

The third tool is enforcement actions. Our office has recently adopted six different clauses dealing with brokered deposits for use in cease and desist orders and formal agreements. They range in severity from a simple reporting requirement to one that bans the further use of brokered deposits altogether and requires a plan from the bank as to how it will reduce its dependence on brokered deposits.

In addition, we need a uniform capital standard that applies to all financial institutions so as to prevent the incredible growth that has been reported in some savings and loan associations, although not generally in commercial banks.

Incidentally, only 195 of the 4,700 national banks have any brokered deposits at all.

As for the second problem, applying a $100,000 limit per depositor per broker would eliminate the disaggregation by brokers of what would otherwise be uninsured funds into insured amounts. Going that route would preserve the retail market, which should be preserved because it provides benefits to the consumer. A consumer is able to call up a broker and buy a $10,000 CD with the yield and maturity he wants as well as with a liquidity feature. The consumer benefits by being able to sell the CD back to the broker who is making a secondary market, thereby avoiding an early withdrawal penalty, while the institution benefits from having the funds remain on deposit. Such retail deposits would be insured anyway, and I see no reason to deprive the American public of a convenient means of buying small banks' CD's.

I also see benefits to depository institutions, which have significant costs associated with their distribution systems, costs that they must reduce. Brokered deposits offer a low-cost way of obtaining funds, as well as an effective means of matching assets and liabilities.

Because there are significant benefits to brokered deposits, I do not think we ought tc do away with them. In recent testimony before a House subcommittee, however, I said I would be willing to live with a 15-percent overall cap on brokered deposits with the level permitted an individual institution equal to twice its capital-to-asset ratio. If an institution had 3 percent capital, for example, it could have 6 percent of its assets funded by brokered deposits. If it had a 6-percent capital ratio, it could have 12 percent and so forth. That would also contribute to limiting the dramatic growth that we are seeing in problem banks and problem savings and loan associations.

In sum, I think there are better solutions than the proposed rule, and I am disappointed that both the Bank Board and the FDIC have been reluctant to sit down and try to work out an alternative to the proposed rule, which, as I said earlier, amounts to regulatory overkill.

The CHAIRMAN. Mr. Callahan, we are all very well aware of the problems of credit unions involved in the Penn Square fiasco. What is your opinion about brokered deposits and how we should handle this issue?

Mr. CALLAHAN. Well, Mr. Chairman, I share with my fellow regulators the great concern that this growth in problem institutions poses for us all. I agree with much of what Mr. Conover has to say because I too feel that not only is this overkill, I really believe that the proposed rules are too little too late. The marketplace has already found a way around the rule. The credit union money will be moved by brokers selling information rather than handling transactions. They will merely follow many of the lists that are already available in the press and what have you.

Consequently, I believe that the solution has to be to attack the problem head-on, which are problem institutions, and much of what Mr. Conover had to say goes along those lines and I too believe that it is a common problem that we all should be putting our heads together to find out a way to work out some way of heading these things off.

I don't think regulating brokers is going to solve any of our problems.

Mr. ISAAC. Mr. Chairman, I feel like Alice in Wonderland this morning with the Comptroller arguing for States rights and more regulation rather than letting the marketplace work.

CREDIT UNIONS ARE CREATING A PROBLEM

As for Mr. Callahan's comments, the credit unions are a large part of our problem. They are dumping money in problem banks and S&L's around the country. That one in Texas that failed the other day had credit union money from Michigan. Penn Square had substantial credit union money, including some credit union money close to home here. The credit unions are a substantial part of the problem. Mr. Callahan is right in saying that the credit unions will likely go directly to problem banks with their money by using lists of banks that pay the highest rates, if we cut out the use of brokers. The FDIC in its testimony has proposed that we go a step further and either by regulation or by statutory amendment, depending on whether we need the statutory amendment, provide that financial institutions not be considered insured depositors. This will preclude a credit union from dumping money into failing S&L's and banks and receiving a subsidy from the Federal Government and the American public. We are going to attack that problem and we hope to prevent credit unions, the Bureau of Indian Affairs, and others who ought to know better from going around the country shopping for the highest rates available from lousy banks. We are not trying to regulate this practice. We want to let the marketplace operate and sort out the good banks from bad banks.

We simply can't deregulate liabilities, and let banks and S&L's pay whatever they want, and at the same time tell the people who put this money in these institutions we will bail them out if the institution gets in trouble. Those two don't work together. And you can't regulate it. Todd says get on the problem banks. Well, there are problem banks out there that we don't know about right now and we're not going to know about them until its too late—until we've lost hundreds of millions of dollars on them.

Ed Gray tells the story of an S&L that had substantial brokered deposits. They put a cease and desist order on it. The institution had a signed agreement saying its wouldn't take any more brokered deposits. They had an examiner in the S&L, and at the very time they were in there the S&L got on the phone, ordered up $40 million in brokered funds and put them out in bad loans.

We cannot regulate this. We are going to have to trust the markets. Now I am not saying we cannot do some things in regulation. We are certainly trying to. We have increased our monitoring. We have increased our enforcement efforts in respect to problem banks. We have really tried to increase the pressure. But the question is, what do you want the deposit insurance system to do? We cannot bail out the entire economy, and if we do not come down on insured brokered funds, we are going to be bailing out the entire economy for as long as we can—and that's not going to be much longer.

The CHAIRMAN. Before I let you respond, my time is up. Senator Hecht, do you have additional questions?

Senator HECHT. Yes. I want to ask one simple practical question. These problem banks that have been taking in brokered loans, have you regulators insisted they increase their capital?

Mr. ISAAC. When you have a problem bank, particularly one that's using excessive amounts of brokered funds, you have limited options. Yes, we try to get the capital increased. It is usually too late to do so. Not very many people want to buy stock in an institution that is in trouble.

Senator HECHT. But do you think there's a timeframe when you see the assets of a bank go up do you regulators demand that they increase their capital to stop a lot of these problems?

Mr. ISAAC. We do, but, unfortunately, by the time you know there is a problem, too often it's too late and you can't do anything about it.

Senator HECHT. We have to leave. One question I want to ask Mr. Isaac and Mr. Conover. You both said basically that more competitive prices for the consumer by allowing these extra activities—insurance, real estate—do you feel at the present time the consumer is paying too much for their real estate brokerage services, too much for their insurance services, too much for their securities services?

Mr. ISAAC. I don't know for a fact that they are or not. I would say that if we had a more competitive marketplace I would be convinced that they were not because the marketplace would sort it out. I think it's fairly clear that in areas like discount brokerage and life insurance, substantial savings could be brought to the American public by more competition. We've already seen it. I gave some examples in my testimony on that.

Senator HECHT. Mr. Conover, would you address that?

Mr. CONOVER. Yes, I would agree with Mr. Isaac on that. I think that by permitting these combinations and thereby producing a more efficient distribution system for these products and services some significant savings could be passed on to the public.

Senator HECHT. The consumer is paying more for the bank services today than they did years ago because of particular situations as far as interest rates. Do you agree on that?

Mr. CONOVER. Since interest rate ceilings have come off, consumers have benefited to the tune of some $13 billion in additional interest, while at the same time they have been charged an additional $3 billion in service fees. Consumers, then, are better off to the tune of $10 billion today as a result of the removal of interest rate ceilings.

One of the reasons service fees are increasing is that the Congress has not provided any additional product power for banks. What we are looking at is a job that is half done, a house that is half built. That is why it is so important to get this legislation passed so the American public can derive the full benefits of the deregulatory effort.

PREVENTION OF TIE-INS

Senator HECHT. How would you prevent tie-ins?

Mr. CONOVER. Tie-ins are obviously a significant problem. I think that the specific provisions in the bill regarding tie-ins have to be looked at very carefully. The congressional concern with tie-ins is no different from that of the regulators. The prohibitions against tie-in sales have to be strong. I think the provisions in the current bill are adequate, but if they are not, they ought to be adjusted as you go forward with this legislation.

Senator HECHT. Mr. Isaac.

Mr. ISAAC. I don't think tying is a problem at all unless you continue to place in the way of competition these artificial barriers. The best protection against tying is a competitive marketplace. If I, as a consumer, have the option of selecting services from 1,000 different institutions, or 2,000, or 10,000 different institutions rather than 1 or 2 that have a statutory lock on my market, there can't be tying. I can go anywhere and get those services. You can only tie if you have something unique to offer and when you create these small markets through artificial barriers like Glass-Steagall, McFadden, and Douglas, you are laying the foundation for tying arrangements because you are preventing the marketplace from getting in there and offering services to people.

Now having said that, I have no objection whatsoever to the strongest possible antitying measures that Congress could adopt because, I do not believe tying will be a problem if you get rid of the artificial barriers. Because I do not think it is going to be a problem, I have no objection to the prohibition and you can make it as strong as you want.

Senator HECHT. Thank you.

The CHAIRMAN. Thank you, Senator Hecht.

Senator Tower wished to be here and, Mr. Gray, he has some specific questions concerning brokered deposits concerning the FHLBB's close down of the Empire Savings & Loan of Mesquite, Tex. So I would submit those to you for your response in writing and he would like a reply to his questions as soon as you can possibly get them back to him.

Gentlemen, I have additional questions that I will also submit to each of you for your response. You know how the Secret Service is, you can not be late for a meeting with the President or they won't let you in. So I will have additional questions and I also have a letter I want submitted for the record from the National Association of Federal Credit Unions concerning the share draft increases.

[Letter from the National Association of Federal Credit Unions follows:]

[Responses to written questions of Chairman Garn and Senator Tower follow:]

NAFCU
National Association of Federal Credit Unions
P.O. Box 3769
Washington, DC 20007
703/522-4770

March 19, 1984

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

During testimony on S. 2121 before your Committee on February 28, 1984, I reported that the National Association of Federal Credit Unions was surveying membership as to their desires, concerns or recommended position on this important legislative proposal. You commented that day that you hoped we would continue to review proposed changes with our membership and "communicate to the Committee what their feelings are."

We are satisfied at this time that sufficient membership response has been received to give us a positive position on the bill. NAFCU's membership supports the capitalization of the share insurance fund as proposed in S. 2121. There is enough concern expressed by our members, however, for the NAFCU Board of Directors to ask for a phase-in of the capitalization. This would allow time for credit unions to liquidate or adjust investments and to plan their cash flow to provide the amount required to further capitalize the NCUSIF.

Fortunately, S. 2121 includes a provision for a phase in. It states:

> The Board (NCUA) may, in its discretion, authorize insured credit unions to initially fund such deposits over a period of time in excess of one year, if necessary to avoid adverse effects on the condition of the credit union.

NAFCU's Board, acting for its membership, asks for a three-year phase-in for all credit unions. Such an arrangement would infuse approximately $270 million in new capital into the NCUSIF in each of the next three years. This would reach the goal of capitalizing the fund at 1.0% of insured shares above the present equity of 0.3% of insured shares in a manner less burdensom than would be a single deposit. At the same time, credit unions would help to reduce the federal deficit each year at a rate nearly three times the amount anticipated in recent proposals to tax credit unions.

We are pleased to support the legislation that will make the NCUSIF stronger than ever. We applaud NCUA for developing this bold and straightforward plan. We also thank you, Mr. Chairman, for your continuous interest in a strong credit union system in the United States. Your foresight in offering S. 2121 at this time is commendable.

NAFCU stands ready to offer all assistance we can to see that S. 2121 becomes law of the land with those conditions we have asked for being fully considered.

Sincerely,

John J Hutchinson

John J. Hutchinson
President

JJH:yrz

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

May 31, 1984

The Honorable Jake Garn
Chairman
Committee on Banking, Housing,
  and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

This is in response to your letter of April 11, 1984 in which you ask several questions stemming from your hearings on financial institutions deregulation legislation.

1. It is our belief that the traditional distinction between commercial banks and thrifts is no longer valid. From the standpoint of a consumer looking for banking services, there is no difference between the two. Moreover, as a result of recent changes in the Home Owners Loan Act, federally-chartered thrifts can now compete with commercial banks in terms of a whole array of powers encompassed in the term "commercial lending." Utilizing these authorities, a thrift can totally forsake its housing mission and devote all its resources to commercial lending.

   I feel that institutions which make commercial loans should be subjected to the same restrictions as commercial banks. If it is government policy to continue to provide support to the residential mortgage market via tax policy and access to lower cost credit, then such support should be available to all mortgage lenders, including commercial banks.

2. All consumers benefit from the more competitive and efficient marketplace which deregulation produces. In the aggregate, deregulation has meant a net gain in interest earned by consumers despite increased service charges. While large depositors may benefit more than small depositors, deregulation was intended to allow depositories to compete

more effectively with money market mutual funds, etc., and to reverse the severe disintermediation caused by the latter. In these terms, deregulation has been successful in returning funds to depository institutions and in shoring up the depository system as a whole.

As we noted in our testimony before the Committee on March 21, 1984, consumers will benefit from banks and bank holding companies being able to offer a full range of financial services including securities, insurance, and real estate services and from firms engaged in nonbank financial services being able to affiliate with banks. Clearly, increasing the number of potential providers of each service will enhance competition and result in lower prices. The extensive distribution systems that banks now operate can be utilized to significantly lower the delivery costs of securities, real estate, and insurance products.

Increased competition will also encourage a more varied array of services, tailored to the differing needs of individual consumers and small businesses. Moreover, with the ability to integrate financial services into one package, product designers will have new freedom to combine financial services in new and imaginative ways.

Greater flexibility to design financial services and the easing of geographic restrictions will also improve the flow of credit. For example, permitting banks to pool mortgages and sell mortgage-backed securities will both enhance the flow of funds to housing and allow a larger number of individuals to invest in the mortgage market.

Removal of the restrictions against offering a full range of financial services will result in stronger community institutions. An affiliation of small community banks, insurance agents, and local independent real estate firms will be better able to compete with large organizations such as Merrill Lynch, Sears, and Citicorp, that are already operating nationwide. Thus, individuals and small businesses will be able to obtain new products from community institutions familiar with local needs.

While not every consumer will utilize the new services authorized for banks or patronize bank-affiliated financial services providers, the public as a whole will benefit as restraints are lifted and more competitors can vie for their financial services dollar.

3. Securities underwriting is not necessarily riskier than commercial lending. While in underwriting corporate equities, for example, a securities firm may be at risk for thirty days before an issue is sold, a commercial bank may be at risk for years while a borrower repays a large loan. Underwriting revenue bonds, mortgage-backed securities, and mutual funds involves even less risk than corporate equities and certainly less than commercial lending.

   A more important question concerns the potential conflict of interest that could arise if a depository institution involved in commercial lending is affiliated with a securities firm. We believe that such affiliations should not be possible for commercial banks or thrifts engaged in commercial lending. When financial institutions do not engage in commercial lending, however, as in the case of consumer banks, they should be allowed to affiliate with securities firms or other nonfinancial corporations since there would be no potential for unfair allocation of credit.

I hope this information is helpful to the Committee.

Sincerely,

C. T. Conover

C. T. Conover
Comptroller of the Currency

Response to Written Questions From Senator Garn to Edwin J. Gray, Chairman
Federal Home Loan Bank Board

Questions for Chairman Gray

Question 1.a. Home Financing

On page 4 of your statement you emphasize that FSLIC-insured thrifts "maintained approximately 80% of assets in qualifying home loans and related assets." Then on page 13 you indicate that the lower 60% of assets test in S.2181 is not enough. If thrifts have so much of their funds in housing, why not have a 60% test?

Response 1.a.

It is very important to point out that my testimony does support a 60% housing-based portfolio investment as the cutoff for defining savings institutions entitled to such benefits of the thrift regulatory framework as unitary diversification and service corporation authority as it exists under current law for federal savings and loans.

The main point of the argument on page 13 is that the types of qualifying assets--rather than the designated quantity--in S.2181's housing-oriented test may prove counterproductive to efforts of thrifts with a true housing commitment to restructure their portfolios to provide contracyclical income to supplement primary mortgage finance activity, as the Garn-St Germain Act so clearly intended. Specifically, as the formal testimony indicates, I believe the S.2181 60% test could severely hamper thrift restructuring by excluding liquidity items from the housing "basket" of qualifying assets.

A savings institution's maintenance of such liquidity investments is a prudent and vital part of portfolio management to ensure its continued ability to originate and hold residential loans, and to preserve its eligibility for the housing support system provided by the Federal Home Loan Banks.

Section 5a of the Federal Home Loan Bank Act requires that all member institutions maintain a ratio of liquid asset holdings against total deposits and short term borrowing within a range of 4-10%, the precise ratio and definition of liquid assets being determined by the Bank Board. Since liquid assets held to meet this requirement do not provide usable liquidity, member institutions typically hold liquid assets in excess of the requirement that can be liquidated by sale or redemption to obtain funds needed for lending purposes or to meet withdrawal of deposits.

Rapidly changing and volatile economic conditions may dictate holdings which are substantially above those required by the regulations. The interest-rate-risk crisis of 1981 to 1982 demonstrated most starkly that substantial increases in liquidity are sometimes absolutely vital for institutions to meet unanticipated economic conditions. More recently, changes in the economic environment led many institutions to hold liquid assets of well over 12%, on an end-of-month basis, in 1983 even though the liquidity ratio required by the Bank Board was only 5%. This excess liquidity resulted from the introduction of the Money Market Deposit Account, as institutions both temporarily invested the large inflow into such accounts in liquid assets pending more permanent investment, and raised their desired level of excess liquidity because of the potential volatility of these short term deposits.

I have attached for your information a table which is the basis for our conclusion on page 4 of the March 21 testimony, that breaks down the types of qualifying assets held by FSLIC-insured S&Ls, as of June, 1983, and are "qualifying" for purposes of determining eligibility for ownership by a diversified unitary under the Garn-St Germain Act and I.R.C. § 7701(a)(19)(C).

As the table indicates, FSLIC-insured S&Ls in mid-1983 had invested, in the aggregate, roughly 10% of assets in liquidity items, including cash and government securities, which would not be available to be counted as qualifying assets under S.2181. Unless such liquid asset holdings are considered qualifying, the amount of discretionary lending permitted for thrifts which wish to affiliate with diversified unitaries, or exercise full service corporation powers, will be substantially smaller than suggested by the difference between the minimum qualifying asset ratio and 100%. For example, the amount of discretionary diversification consistent with the Garn-St Germain powers for federals would not be 40%, but 40% minus these liquidity items.

In my view, these factors demonstrate that any housing-based asset test which excluded liquid assets from qualifying status would irretrievably harm the future prospects of the industry to restructure and diversify, consistent with the new powers provided by the Garn-St Germain Act, in a way that is critical to support their home finance mission in all types of economic scenarios.

Question 1.b.

You would include liquidity investments, cash, government securities and other items in the 60% basket. But wouldn't this make thrifts look more like many banks; for example, a thrift could have 40% or less of its assets in residential housing and, because of cash, liquidity investments and government securities amounting to 20% of assets, could meet the 60% test?

Response 1.b.

In my view, the mere ability to invest in liquidity items is not the distinguishing factor between banks and thrifts. The distinction is a historic and continuing commitment of the thrift industry to residential lending, while banks have focused primarily on short term commercial loans and business deposit gathering.

The current Internal Revenue Code asset test linked to unitary diversification by the Garn-St Germain Act already includes liquidity items such as cash and government securities. Yet the configuration of the industry's asset composition since passage of the Garn-St Germain Act shows a continued overwhelming concentration in residential lending. At the end of September, 1983, FSLIC-insured institutions had over 67 percent of assets invested in residential mortgages and mortgage-backed securities, and total mortgages and mortgage-backed securities (including those on non-residential property) comprised over 75 percent of assets. For commercial banks on the same date, residential mortgage holdings accounted for only 10 percent of assets and total mortgages for only 17 percent (bank data do not include mortgage-backed securities, since information on such holdings is not available).

The facts presented in response 1.a. above also strongly refute the conclusion that including liquid assets in a housing-based portfolio test would make thrifts more closely resemble commercial banks. These facts demonstrate that maintaining liquidity investments is a crucial supplement to--not a subversion of--thrifts' primary housing mission. For thrifts, liquid assets are not vehicles for investment but serve merely as a way to hold cash temporarily pending investment in mortgages and other loans. We believe that statutorily limiting such liquidity holdings is unnecessary as earnings on liquidity never exceed the amounts that can be earned on mortgage investments.

Moreover, there are a number of provisions in current law which give the Bank Board authority to curb potential excessive investment in liquidity to the detriment of the industry's housing commitment. Thus, the Home Owner's Loan Act requires that Federal associations provide credit for homes and other goods and services in addition to serving as deposit gatherers. The Federal Home Loan Bank Act conditions membership upon maintaining a management or home financing character consistent with sound and economical home financing, and the National Housing Act also makes the existence of sound and economical home financing a litmus test for the granting of FSLIC insurance of accounts.

Finally, S.2181 itself supplements these existing guidelines by granting the Bank Board authority to interpret and implement the qualifying assets test, and this would allow the Board to devise appropriate regulatory safeguards if problems with excessive liquidity investments arose. For example, one alternative would be to permit liquid asset holdings to be counted as qualifying assets in amounts no greater than the sum of the liquidity ratio required by the Board at the time plus some historical average of excess liquidity, with emergency waiver provisions to accommodate changing economic conditions.

Question 1.c.

You propose giving thrifts credit under the 60% test for secondary market activities. Would this not lead to the conclusion that mortgage bankers should qualify for certain thrift "benefits", such as access to advances from the Federal Home Loan Banks?

Response 1.c.

I do support some method of recognizing in a housing-based qualifying assets tests the contribution to housing finance made by thrifts participating in the secondary market. However, I believe such recognition should form a supplement, not a substitute, for the primary focus of a qualifying test on home loans held in portfolio. Therefore, I do not believe such an accommodation in any way suggests that a "pure" mortgage banking operation should qualify an institution for Federal Home Loan Bank membership or its benefits. I believe the historic focus of that system should be preserved to support institutions with a primary commitment to originating mortgage loans to hold as portfolio investments.

Question 2.

You have said that thrifts aren't banks because thrifts have a significant commitment to housing. But doesn't a thrift do many things today besides originate mortgage loans and, in recognition of these changes, doesn't it make sense to define "bank" and parallel that idea in the qualified thrift lender area (with the alternative 25% of assets in commercial loans test)?

Response 2.

As I stated in my formal testimony before the Committee, I believe two of the primary goals of an asset test should be to acknowledge and reinforce the historically distinct operating functions of banks and thrifts, and to preserve the independent regulatory structure created to support and encourage home mortgage lending by federally insured thrifts.

In terms of these goals, defining a thrift by reference to a commercial lending test is totally self defeating. Clearly, the Garn-St Germain Act and state deregulatory initiatives have encouraged thrifts to diversify. But every indication we have shows that the industry has maintained an overwhelming concentration of its assets in home mortgage loans and related assets in the time since the passage of the Garn-St Germain Act, and that this portfolio dedication to home loans exceeds that of commercial banks by an enormous margin. The 25% commercial loan alternative in S.2181 fails to recognize this affirmative home lending focus which provides such a clear cut functional boundary between commercial banks and thrifts.

Not only does the 25% test fail to reinforce this crucial distinction in the most effective way, but it would in addition qualify almost 10,000 commercial banks as thrifts conceivably eligible for the benefits of the Federal Home Loan Bank System, without requiring any home loan commitment from such entities. This approach could squander the limited resources of that system and subvert the purposes of the separate thrift regulatory structure, diminishing rather than enhancing the benefits which that system has so long provided to American homeowners.

Percentage Distribution of Assets of FSLIC-Insured Institutions
June 1983

Specified in Internal Revenue Code		81.9%
Residential Mortgage Loans	57.4%	
Mortgage-Backed Securities	10.7	
Home Improvement Loans	0.7	
Mobile Home Loans	0.4	
Loans Secured by Deposits	0.4	
Education Loans	0.3	
Repossessed property	0.4	
Fixed Assets	1.4	
Cash and Deposits	4.8	
Government Securities	5.1	
All Other	0.3	
Not Specified in Internal Revenue Code		18.1
Total		100.00

Note: Some classifications are partially estimated.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR TOWER

FROM

EDWIN J. GRAY, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Question 1:

"Mr. Gray, on March 14, the FHLBB closed down the Empire Savings & Loan Association of Mesquite, Texas. In doing so, the Board stated that brokered deposits was a "contributing factor" in Empire's collapse. Is that true? How so? What documentation do you have to support this claim?"

Answers:

a. This statement is true.

b. Brokered deposits provided the funds used to make the loans that resulted in the losses that caused the "collapse" of Empire.

c. The records of Empire, together with independent appraisals obtained by the Board, clearly document that preceding assertion.

Question 2:

"Mr. Gray, how long was Empire on your troubled list of institutions before you decided to shut it down? Was there any indication before its collapse that the institution was a beneficiary of brokered deposits? If you were aware for at least two years that Empire was failing, why did you decide to close it only last Wednesday?"

Answers:

a. The Board discovered that Empire not only was in trouble but, in fact, failing in August 1983, when an on-site examination of its records revealed that its true financial condition had been concealed by its reports to the Board, which indicated a growing association with substantial earnings and net worth. From August 1983 until the day that Empire was closed, the energy and resources of the Board were devoted to developing the evidence needed to justify that action.

b. Yes. The extraordinary increase in savings indicated by Empire's reports to the Board could only have been achieved with brokered deposits.

c. The Board was not aware for at least two years that Empire was failing.

Question 3:

Who were the brokers that deposited funds into Empire? How much did each of them deposit?

-- Did Merrill Lynch have any deposits in Empire?
-- Dean Witter?
-- Shearson/American Express?
-- Prudential?

If none of these companies deposited funds in Empire, please characterize the brokers involved. Would you say these brokers are typically "hot money" brokers?

Answers:

a. The following chart summarizes the funds deposited by brokers at Empire S&L, Mesquite, Texas.

Broker	Total No. of Accounts	Total Dollars	
High Yield	70	$ 7,063,000	
Continental	84	8,541,000	
Continental Fund	47	4,718,000	
First United	1,107	114,694,000	
First Atlantic	309	36,415,000	
First Empire	69	6,932,000	
Long Beach Savings	80	8,935,000	
National Money Market	41	4,142,000	
American National Money Market	1	100,000	
American Money Market	33	3,317,000	
Connie Tate	1	100,000	
First Employee Fund	1	100,000	
Harper Wilder & Assoc.	5	1,004,000	
International Investment	17	1,711,000	
Peninsula Savings	34	3,422,000	
Metro Securities	1	100,000	
Other Jumbo Accounts	580	58,903,000	
TOTAL	1,900	$201,294,000	(66% of total savings
Other Jumbo Accounts*	580	58,903,000	
TOTAL JUMBO ACCOUNTS	2,480	$260,197,000	(86% of total savings

*Theses accounts are currently being reviewed to determine if they were brokered into Empire.

The following brokers did not have deposits at Empire:

- Merrill Lynch
- Dean Witter
- Shearson/American Express
- Prudential

b. & c. Brokered funds at Empire were primarily in single $100,000 amounts with maturities of one year or less, with an average maturity of six months. First United and First Atlantic brokered over 75 percent of the total brokered deposits into Empire. Both of these brokers had funds in previous insurance cases. First Atlantic had brokered funds into Manning S&L, Cleveland, Ohio and State Savings of Clovis, New Mexico. In addition, First Empire and Long Beach Savings brokered deposits into Cleveland S&L.

Question 4:

Of the total amount of brokered funds in Empire, how much (net percentage) was:

a. insured (aggregate)
b. uninsured
c. insured individual
d. insured institutional

Answer:

As of December 31, 1983, brokered savings composed approximately ninety percent of Empire's total savings base. During the past two months, this figure decreased to approximately sixty-six percent of Empire's total savings. Of the $302.9 million total savings in Empire, $201.3 million was deposited by brokers. At this point in the settlement process it is too early to determine the exact uninsured amount of funds at Empire. However, an estimate of $9.6 million in uninsured funds was made after analysis of savings records immediately after the closing.

Less than five percent of total brokered funds were for individuals. Over eighty-five percent of total brokered deposits were for institutions. This consisted primarily of credit unions, savings and loans, and banks. These types of accounts usually contain corporate funds and are insured to $100,000. At Empire most of these accounts were for single $100,000 amounts. In general, only accrued interest on these accounts was uninsured.

Question 5:

Messrs. Gray and Isaac, last week in testimony before Congressman Barnard's Subcommittee you both rejected what I thought was a reasonable compromise proposed by the Comptroller. Why?

a. What alternatives have each of you considered?
b. What, if any, alternatives will you propose?

Answers:

The Comptroller of the Currency presented a five part program in his testimony on March 14, 1984, before Congressman Barnard's Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations:

> (1) limit insurance coverage to a total of $100,000 for all funds placed by a depositor through any single broker;
>
> (2) limit the amount of brokered deposits in any bank or thrift to twice the institution's net worth or to 15 percent of assets, whichever is greatest;
>
> (3) impose a common definition of capital and a common capital standard for all depository institutions;
>
> (4) develop (a) a mechanism to make sure that uninsured depositors experience some degree of loss in government assisted mergers and (b) a risk related premium structure; and
>
> (5) increase public disclosure of, and provide common standards for, information on the financial condition of banks and thrifts;

We believe that this proposal will not effectively deal with the many problems presented by the growth of third-party brokerage of insured accounts. Instead, portions of the proposal may have significantly harmful effects on our nation's savings institutions, and ultimately on the Federal Savings and Loan Insurance Corporation (FSLIC).

The first proposal would require the FSLIC to obtain, update, and maintain lists of all depositors that have placed funds in FSLIC-insured institutions through deposit brokers, a task of Orwellian proportions. Each time that an FSLIC-insured institution is closed, we would have to (1) determine whether the depositor has placed funds through a deposit broker, (2) identify that broker, (3) determine whether the depositor had used that same broker to place deposits in any other insured institutions, and (4) determine whether any, and if so, how much, insurance already had been paid to that depositor as a result of deposits placed through the same broker. This would be significantly more time consuming than simply determining whether the deposit was placed by or through a broker. This proposal would therefore significantly slow the pay-out process, and this delay could adversely affect consumer confidence in the FSLIC, thereby decreasing public confidence in insured saving institutions. There is also a question of whether this agency would have authority under existing statutes to aggregate the interests of a depositor in several different institutions for purposes of determining insurance.

The second proposal would be more burdensome and less effective than the approach adopted by the FDIC and the Bank Board. The proposal sets a limit that may be too high for some troubled institutions yet too low for some healthy institutions. It would continue to encourage brokers to make investment decisions based only upon the rates offered by the institution, since all deposits placed by the broker would be insured even if the deposits increase the amount of brokered deposits above the prohibited level. Lastly, this proposal posits net worth as the only index for determining whether use of brokered deposits by an institution would be safe and sound. In contrast, the rule adopted by the agencies allow institutions to attract funds based upon the institution's creditworthiness (a standard composed of many factors, including net worth) and will not defeat the liquidity benefits of brokered deposits for well run institutions.

The suggestion that common capital standards and definitions are an appropriate response to the problems presented by brokered deposits ignores the differences between savings and loan institutions and commercial banks. This suggestion does not take into account the particular problems faced by insured saving and loan institutions as Congressionally designated instruments of public policy. It also fails to anticipate the impact on the savings and loan industry, which is in the process of recovering from one of the most difficult periods in its history. Lastly, it legitimizes the sale of FSLIC-insured deposits by deposit brokers while imposing additional costs on the institutions that pay all of the premiums that fund the FSLIC.

The suggestion to create a mechanism to ensure that uninsured depositors experience some degree of loss in government-assisted mergers would only serve to enhance the proliferation of third-party deposit brokers. This suggestion would have the same effect as the failure of the Penn Square Bank, which has led depositors to use brokers to divide their investments into parcels of under $100,000 each so that their investments are fully insured. It would also lead large depositors to divide their deposits even when placed in institutions believed to be "too large" to be allowed to fail. Thus, this suggestion would only increase the amount of funds placed by brokers in insured accounts and would thereby increase the costs to the FSLIC.

Risk related premiums would also not be as effective as the rule promulgated by the FDIC and the Bank Board. Increasing the premiums may only add to an institution's costs, thereby adding pressure to seek investments with higher rates of return. Institutions facing the possibility of failure would not be deterred by higher premiums from making high-risk investments --if they succeed they can pay the premium, if they do not there will be no further premiums assessed because they will be closed. Assessment of higher premiums might discourage the acquisition of troubled banks and thrifts, or increase the amount of federal financial assistance required in connection with supervisory solutions for such institutions. Lastly, this suggestion would legitimize the sale of FSLIC-insured deposits by entities that pay no premiums at all to the FSLIC, while increasing the premiums of those institutions that do support the insurance fund.

Increased public disclosure of the financial condition of banks and thrifts would be meaningless to the fully-insured depositor. Since deposit brokers can divide an investor's funds into parcels of less than $100,000 each so that the total investment is fully insured, increased disclosure would only cause more investors to use deposit brokers to obtain full insurance. For the average consumer, increased disclosure of the financial condition of troubled institutions may cause unnecessary panic leading to runs on these institutions. This is absolutely contrary to the primary purpose of the federal deposit insurance system which is dedicated to preserving the stability of our nation's depository institutions.

a. The Bank Board and the FDIC considered a number of alternative suggestions. A succinct description of these alternatives and our comments on them are set forth in the preamble to the final rule on pages 10 through 14 (a copy of the rule is enclosed).

b. The alternative adopted by the Bank Board and the FDIC is set forth in the enclosed final rule on limitations on the insurance coverage of brokered deposits. The Bank Board also adopted an interim temporary rule limiting the amount of brokered deposits that an institution with less than 3 percent net worth may accept during the phase-in of the insurance limitation rule (a copy of the interim temporary rule is also enclosed).

No. 84-142

Date: March 26, 1984

FEDERAL HOME LOAN BANK BOARD

12 CFR Part 563

Brokered Deposits; Limitations Applicable to Institutions With Low Net Worth

AGENCY: Federal Home Loan Bank Board

ACTION: Interim final rule

SUMMARY: The Federal Home Loan Bank Board ("Board"), as the operating head of the Federal Savings and Loan Insurance Corporation ("FSLIC" or "Corporation"), has adopted an interim final rule amending the regulations applicable to institutions the accounts of which are insured by the Corporation ("insured institutions"), by limiting to five percent the amount of deposits that certain insured institutions may acquire by or through a deposit broker. This rule will apply only to insured institutions whose net worth at the beginning of any quarter is less than three percent of their liabilities, without averaging or phase-in calculations. The amendment is intended to address the possibility that institutions with low net worth could have accumulated large amounts of insured deposits through brokers prior to the effective date of the final rule adopted today by the Board limiting insurance on such deposits. This regulation will expire on October 1, 1984.

DATE: Effective from March 26, 1984, through September 30, 1984.

FOR FURTHER INFORMATION CONTACT: Wendy B. Samuel, Attorney, (202) 377-6447, Federal Home Loan Bank Board, Office of General Counsel, 1700 G Street, N.W., Washington, D.C. 20552.

SUPPLEMENTARY INFORMATION: On November 1, 1983, the Board (together with the Federal Deposit Insurance Corporation) issued an Advance Notice of Proposed Rulemaking soliciting comments on the use of brokered deposits by insured institutions. 48 FR 50339. On January 23, 1984, the FDIC and the Board issued a proposed rule which would limit the insurance on accounts placed by or through a broker to $100,000 per broker. *See* 49 FR 2787 (January 23, 1984). That regulation was adopted substantially as proposed, in final form, today, March 26, 1984, effective October 1, 1984. 49 FR ______

Among the concerns raised by the Advance Notice, the proposed rule, and the comments received was the problem presented by troubled or weak institutions having unlimited access to brokered funds. Access to brokered deposits was seen as making it possible for institutions with little net-worth "cushion" to continue operating beyond the time at which natural market forces would otherwise have precipitated their failure. Brokered deposits also enable insured institutions to obtain deposits more rapidly than they may be able to find safe and sound investments to purchase with the funds thus obtained, and the Board's experience indicates that an institution with low net worth is particularly vulnerable to failure under such circumstances. Noting this possibility, a number of commenters suggested increased monitoring and supervision of brokered funds acquisition by institutions with low net worth. Commenters also suggested that a limit be placed on the amount of brokered funds a troubled or weak institution may acquire.

The Board is seriously concerned by a perceived trend toward rapid increases in the deposit bases of troubled and potentially troubled institutions without a concomitant increase in their net worth. The level of brokered deposits in insured institutions has risen rapidly since the beginning of 1980. Of those institutions which obtained more than five percent of their deposits through brokers, 42 percent had regulatory net worth below three percent. In 1983, two-thirds of the insured institutions closed by the FSLIC had brokered deposits in excess of five percent of their total deposits. The Board is concerned about the adverse effect that the acquisition of substantial amounts of high-rate brokered deposits by institutions with a low net worth may have on such institutions and ultimately on the FSLIC.

While the Board believes that the final rule adopted today limiting insurance of brokered deposits will reduce the availability of such funds to weak or troubled institutions, it is also concerned that such institutions will seek to take in substantial amounts of insured brokered deposits prior to the effective date of that rule. The delayed effective date, while necessary to permit insured institutions to adjust to the final rule limiting deposit insurance for funds placed by or through brokers, may offer an incentive for weak or thinly-capitalized institutions to accept large amounts of brokered deposits without prudent reinvestment plans. While solvent, well-managed institutions should be able to absorb any losses associated with brokered-fund investments in the few months before the effective date, an institution with little net-worth cushion would substantially increase its chances of failure.

Consequently, the Board is adopting this interim final regulation to prohibit institutions with low net worth from having more than five percent of their deposits acquired by or through deposit brokers. "Deposit broker" is defined as in the final regulation limiting insurance coverage for deposits obtained by or through brokers. (49 FR _________). The definition includes any person or entity engaged in the business of placing or listing for placement deposits of an insured institution. It also includes agents or trustees who establish an account to facilitate a business arrangement with the institution to use the proceeds of the account to fund a prearranged loan. Excluded from the definition are: (1) an insured institution, with respect to accounts issued by that institution; (2) employees of the insured institution, with respect to accounts issued by their employer; (3) trust departments of insured institutions; (4) trustees of pension and other employee-benefit funds investing such funds; (5) investment advisers of pension funds; (6) trustees of testamentary trusts; (7) trustees of irrevocable express trusts, to the extent that the beneficiaries of such trusts have not, directly or indirectly, contributed to the corpus of the trust; (8) trustees or custodians of IRA and Keogh deposits; and (9) agents or custodians, provided that the primary function of the relationship pursuant to which the funds are invested is not investment in insured account funds.

This interim final regulation will apply to institutions that have net worth of less than three percent of liabilities. Liabilities are computed in the same manner as in the minimum net-worth requirement of 12 CFR 563.13(b)(2), with two exceptions. First, the calculation of net worth does not permit the averaging of liabilities over a five-year period. The Board believes that five-year averaging permits rapidly expanding institutions to understate their true net-worth requirements. Second, net worth will not be calculated by use of the twenty-year "phase-in" method. That method permits institutions that have not reached the twentieth anniversary of account insurance to "phase in" their net-worth requirement by multiplying three percent of liabilities by a fraction of which the numerator is the number of consecutive years of insurance and the denominator is twenty. Use of the twenty-year phase-in would permit institutions with net worth as low as 0.15 percent of liabilities to avoid limitation of their use of brokered deposits. By excluding the use of the twenty-year phase-in calculation, the rule will permit the Board to limit the use of brokered funds by many potentially troubled and very thinly-capitalized institutions. De novo institutions subject to the requirements of 12 CFR 563.13(b)(2)(iii) will be subject to this regulation if their net worth is less than the percentage of liabilities required by that provision.

Rather than absolutely prohibiting the use of brokered deposits by these institutions, the rule allows funds to be obtained by or through deposit brokers in amounts up to five percent of deposits, determined quarterly. The Board believes that this provision will preserve the ability of institutions with low net worth to raise deposits through brokers without significantly increasing their chance of failure.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the Board hereby certifies that the interim final rule would not have a significant economic impact on a substantial number of small entities. The reason for this certification is that only a few institutions would have both net worth below the proposed requirement and brokered deposits in excess of five percent of deposits. Therefore, an initial regulatory flexibility analysis is not required, 5 U.S.C. 605(b).

The Board finds that observance of the public notice and comment period set forth at 5 U.S.C. 552(b) and 12 CFR 508.11, and the delay of the effective date set forth at 5 U.S.C. 552(d) and 12 CFR 508.14, would be impracticable and contrary to the public interest for the reasons described above.

LIST OF SUBJECTS

12 CFR Part 563

Federal Home Loan Bank Board, Federal Savings and Loan Insurance Corporation, Savings and loan associations.

Accordingly, the Federal Home Loan Bank Board hereby amends Part 563, Subchapter D, Chapter V, of Title 12 of the *Code of Federal Regulations*, as set forth below.

SUBCHAPTER D - FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

PART 563 - OPERATIONS

Add a new § 563.4 as follows:

§563.4 Brokered deposits.

(a) For purposes of this section, the term "net-worth requirement" means (1) an amount at least equal to three percent of all liabilities (i.e., total assets, net of the following: loans in process, specific reserves, and deferred credits other than deferred taxes; minus net worth as defined by §561.13 of this Subchapter) or (2) for institutions subject to the requirements of §563.13(b)(2)(iii) of this Part, the applicable percentage of such liabilities required by §563.13(b)(2)(iii).

(b) Any insured institution which, at the beginning of any quarter, does not meet its net-worth requirement shall not, during that quarter, accept deposits obtained by or through a deposit broker, as defined in § 561.2a of this Subchapter, in excess of five percent of its total deposits.

(c) This section expires October 1, 1984.

(12 U.S.C. 1724, 1725, 1726, 1728)

By the Federal Home Loan Bank Board

J. J. Finn
Secretary

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM WILLIAM M. ISAAC, CHAIRMAN, FDIC

Question

1. New activities as "risky"

You refer to underwriting insurance or securities as being riskier than brokerage activities and Mr. Gray recommends that thrifts not be permitted to affiliate with any firm engaged in securities underwriting or market making.

a. Is securities underwriting any riskier than deciding whether or not to loan an individual or a corporation an institution's money?

Answer: Under certain circumstances securities underwriting may not be any riskier than traditional bank lending. Indeed, there are cases where corporations have encountered difficulties or failed where lenders have lost, though underwriters had not. Securities underwriting does, however, involve risks that are not typical to banks, largely since changing equity prices can quickly increase or decrease profits associated with a particular underwriting. Moreover, underwriting involves considerable leverage. Nevertheless, although securities underwriting may involve somewhat greater risk or at least different risks than traditional bank lending, these risks can be kept to a minimum if certain safeguards mentioned in our testimony are in place.

Question

b. I would appreciate your comments on Mr. Gray's statement that securities underwriting or dealer firms and thrifts should not be allowed to affiliate because of the potential conflicts and abuses.

Answer: Potential conflicts and abuses would exist between depository institutions and their securities underwriting affiliates, but the potential for abuse does not appear to be that great and it can largely be controlled if relatively straightforward safeguards are in place. In fact, in many ways the potential conflicts between a bank and its trust department (which are adequately controlled) may be greater.

One area that appears to cause concern is the potential for "tie-ins" (making one bank service, such as lending, contingent upon the customer purchasing an additional service, such as underwriting). However, the only way the tie-in threat can be effective is if the customer has no viable alternative. In competitive markets customers would simply purchase services elsewhere under more reasonable terms.

Conflicts may also arise if there is an attempt to shift earnings from the depository institution to the underwriter, say, for example, if the underwriter were experiencing financial difficulty. Separate capitalization and funding requirements for the bank and the securities affiliate should protect against this potential abuse.

Question

Thriftiness Test

In light of your proposed definition of what constitutes a bank, would it be necessary also to tighten the definition of what constitutes a thrift?

Answer: The definition of a thrift institution for purposes of qualifying for FHLBB membership and FSLIC insurance should be tightened, regardless of whether or not the definition of a bank is revised. Otherwise, there would be no basis for maintaining a separate regulatory and insurance system for thrifts. A strict percentage-of-assets test based on an institution's mortgage lending activity should be used to define a thrift and to distinguish it from a bank for regulatory and insurance purposes.

The sole, though unconvincing, argument for separate regulatory and insurance systems for banks and thrifts is that thrifts must be treated differently because they specialize in home mortgage lending. Thrifts are subjected to less stringent capital and accounting standards as well as product and geographic operating restraints than are commercial banks.

Such disparate regulatory standards and mounting competitive pressures ultimately will force many commercial banks and other depository institutions not specializing in mortgage lending to apply for regulation as thrift institutions. Commercial banks now may readily convert to thrift status and to FHLBB membership and FSLIC insurance coverage regardless of the level of their mortgage lending activities.

Question

"Pay off" Method of Closing Banks

Recently the FDIC closed two banks and in doing so used a method rather different from the customary "purchase and assumption". Under the new method, the FDIC paid off depositors. Apparently, this was intended to impose some discipline on the marketplace by dispelling a common assumption, verified in practice until recently, that uninsured depositors are in fact insured. Do you intend to proceed further with more "pay off method" closings? What indications do you have that the message has been received in the marketplace?

Answer: The two modified payoff plus cash advance transactions referred to in the question occurred as the result of two bank failures on March 16, 1984. The first transaction (Seminole State National Bank, Texas) was successfully consummated, with the winning bidder offering the same premium for either a modified payoff plus cash advance or a normal purchase and assumption transaction. In the second case (Heritage Bank, California), no potential acquiror was found that was willing to purchase this bank at any price; insured depositors were paid off up to the basic insurance limit and a cash advance was made to uninsured general creditors based on the estimated present value of collections on assets.

Subsequently, the FDIC disposed of the Security National Bank of Lubbock (Texas) on April 16 using the modified payoff plus cash advance method. Although this transaction was structured the same as the two earlier transactions, we had the advantage of the previous experience with respect to presentation of information to potential acquirors and the mechanics of the liability and asset transfer. Overall, this transaction went more smoothly than the two earlier attempts.

It is anticipated that the FDIC will use this method in handling some future bank failures. We are still in the process of evaluating the handling of these types of transactions and the effects on banking and credit markets. We are pleased with the results thus far, and we presently feel that this general method will serve to introduce some market discipline into banking, minimize the disruptive effects of bank failures on bank customers and local markets treat failures of both large and small banks in an evenhanded fashion and result in lower costs to the insurance fund. If, after a reasonable testing period, we continue to be satisfied with the procedure, we will announce our intentions regarding any change in our general method of handling failures.

From what evidence we have at this time, it appears that the marketplace is receiving the message that bank condition is an important input into investment decisions. There have been numerous articles discussing the modified payoff plus cash advance transaction not only in the financial press, but also in the consumer advice columns in the popular press. Moreover, deposit brokers appear to be placing CDs of less than $100 thousand denominations in the weaker institutions to protect accrued interest under the deposit insurance umbrella; this phenomenon was especially evident in the Security National Bank failure. We have not detected any significant shifts of uninsured deposits from troubled banks, although the availability of funding through brokerage may mask any shifts that are occurring.

NATIONAL CREDIT UNION ADMINISTRATION
Washington, D. C. 20456

1984 APR 25 PM 2:26

April 23, 1984

Honorable Jake Garn
Chairman
Committee on Banking, Housing,
  and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to your April 11 letter containing two further questions for the hearing record on S. 2181 and S. 2134. I am pleased to provide the following responses:

Question 1:

Pledge of Flexibility on "Phase In" of 1% Deposit

We have heard concerns from some credit union managers that, though they fully support the 1% insurance fund capitalization, they want to be sure that NCUA takes a flexible approach, and that the options on a phase in be kept open, so that the 1% deposit can be made less burdensome. Can you give us some indication of NCUA's intent about flexibility on the phase in?

Answer: We remain open to any implementation plan which would further reduce costs to credit unions. If a particular phase-in plan is developed which is less expensive than the single payment approach, we will very seriously consider adopting it. At the present time, however, those phase-in plans which we have seen have not only been more expensive to credit unions, but also more expensive and difficult for this agency to administer.

Question 2:

In the letter from NAFCU which I have inserted in the record, NAFCU states it supports the fund capitalization but asks for a phase in of the 1% deposit, presumable over 2-3 years. Shouldn't credit unions be given the option, if they need it, to pay the deposit over a slightly longer period (or more than one payment), in order to minimize problems they might have in selling liquid assets?

Answer: No. We do not think credit unions should be given the option on when or how to make the payment. For very practical reasons, the Fund must know in advance what its resources will be and when it will have access to them. The Board itself has the option to permit a phase in for all credit unions should such an option be developed which is less expensive to credit unions. We do not agree that any problem exists with respect to credit unions selling liquid assets. In the first place, there will be adequate notice given in order for credit unions to plan on the 1% deposit. Secondly, credit unions are extremely liquid and are likely to remain so in the immediate future. Further, there is a vast network of credit union liquidity sources (central credit unions, U.S. Central, and CLF) to meet any isolated problems in making the 1% deposit.

I hope this has been responsive to your inquiry.

Sincerely,

E. F. Callahan

E. F. CALLAHAN
Chairman

The CHAIRMAN. I would also announce that the hearings will continue this afternoon at 1:30 with John Shad, Chairman, Securities and Exchange Commission; and Douglas Ginsburg, Deputy Assistant Attorney General, Department of Justice.

And I would like to welcome Senator Cranston back from the Presidential wars.

Senator CRANSTON. Thank you.

The CHAIRMAN. And I'm personally happy that he is back because I have been walking through the Capitol too many times when people come up in the Capitol and stopped me and said, "Senator Cranston, I will vote for you." So now that he is back in person maybe they will leave me alone. That's also helpful from the standpoint that because I have to leave I am going to turn the committee over to him and the appearance will not be that much different either. He can easily fill in for me in the Chair.

So I would request that when he finishes his questioning he bang the gavel and close the hearing until 1:30 this afternoon, but I do appreciate very much your candid and direct testimony from each of you and we will have some additional questions for you. Thank you very much.

Senator Cranston.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. Thank you very much, Jake. It is a pleasure to be back with you.

I want to make a brief statement and then I have just a few questions.

I've heard from many thrifts, banks, securities dealers and money brokers protesting the proposed rule of the FDIC and FSLIC restricting Federal insurance for brokered deposits over $100,000. I'm concerned with the steadfastness of the regulators in their public comments of their intent to proceed to a final rule despite an overwhelming number of comments to the rule calling for a more moderate approach, and without regard to the fact that hearings are now proceeding in the House and hearings are anticipated in the Senate. I asked Chairman Garn just now if we would have hearings and I said, "I hope we would," and he said, "This is sort of turning into that," but after a while, presumably he will agree that we should have separate hearings because I think we should.

PROPOSED RULE COULD HAVE SERIOUS EFFECTS

We in this committee and in the Congress have spent an inordinate number of years trying to deregulate depository institutions, interest rates, and create a national mortgage market along with choices for small savers. It appears that this proposed rule by a stroke of the pen may virtually destroy that process.

I, therefore, believe that due to the national impact of the proposed regulation that Congress should have an opportunity to take a very serious look at this matter.

I've sent a letter to Mr. Isaac and Mr. Gray requesting that they defer final action on this rule until Congress can complete its review. I will place those letters in the record at this point.

[The following letters were subsequently submitted for the rocord:]

JAKE GARN, UTAH, CHAIRMAN

JOHN TOWER, TEXAS
JOHN HEINZ, PENNSYLVANIA
WILLIAM L. ARMSTRONG, COLORADO
ALFONSE M. D'AMATO, NEW YORK
SLADE GORTON, WASHINGTON
MACK MATTINGLY, GEORGIA
CHIC HECHT, NEVADA
PAUL TRIBLE, VIRGINIA
GORDON HUMPHREY, NEW HAMPSHIRE

WILLIAM PROXMIRE, WISCONSIN
ALAN CRANSTON, CALIFORNIA
DONALD W. RIEGLE, JR., MICHIGAN
PAUL S. SARBANES, MARYLAND
CHRISTOPHER J. DODD, CONNECTICUT
ALAN J. DIXON, ILLINOIS
JIM SASSER, TENNESSEE
FRANK R. LAUTENBERG, NEW JERSEY

M. DANNY WALL, STAFF DIRECTOR
KENNETH A. McLEAN, MINORITY STAFF DIRECTOR

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, D.C. 20510

March 20, 1984

The Honorable Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Mr. Chairman:

I have received many letters from thrifts, banks and securities dealers protesting your recently published proposal to eliminate, effective October 1, 1984, federal deposit insurance for brokered funds over $100,000. In the Notice of proposed rulemaking concern is expressed that access to a national market for brokered deposits provides weak or failing depository institutions opportunity for abuse and that withdrawal of deposit insurance is the appropriate remedy.

Many in both the financial and securities industries believe that this proposed rule is far too sweeping and unnecessarily harms individual savers, sound depository institutions and the interstate flow of funds through the national deposit market.

The Garn-St. Germain Act of 1982 along with the deregulation of interest rates has undeniably contributed to the growth of the brokered funds activity. In light of the fact that the proposed rule will virtually destroy this source of funds for small and medium size thrifts and banks, I believe that it may be more appropriate for Congress to resolve the broad question of the role of deposit insurance in this era of interest rate deregulation.

The House Committee on Government Operations, Subcommittee on Commerce, Consumer and Monetary Affairs is presently having hearings on this subject and hearings are expected in the Senate in the near future. Accordingly, I urge that final action on the proposed rule on brokered deposits be deferred until Congress has had an opportunity to review this matter fully.

Sincerely,

Alan Cranston

Alan Cranston

JAKE GARN, UTAH, CHAIRMAN

JOHN TOWER, TEXAS
JOHN HEINZ, PENNSYLVANIA
WILLIAM L. ARMSTRONG, COLORADO
ALFONSE M. D'AMATO, NEW YORK
SLADE GORTON, WASHINGTON
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JIM SASSER, TENNESSEE
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KENNETH A. McLEAN, MINORITY STAFF DIRECTOR

United States Senate

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, D.C. 20510

March 20, 1084

The Honorable William M. Isaac
Chairman
Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, D.C. 20429

Dear Mr. Chairman:

I have received many letters from thrifts, banks and securities dealers protesting your recently published proposal to eliminate, effective October 1, 1984, federal deposit insurance for brokered funds over $100,000. In the Notice of proposed rulemaking concern is expressed that access to a national market for brokered deposits provides weak or failing depository institutions opportunity for abuse and that withdrawal of deposit insurance is the appropriate remedy.

Many in both the financial and securities industries believe that this proposed rule is far too sweeping and unnecessarily harms individual savers, sound depository institutions and the interstate flow of funds through the national deposit market.

The Garn St. Germain Act of 1982 along with the deregulation of interest rates has undeniably contributed to the growth of the brokered funds activity. In light of the fact that the proposed rule will virtually destroy this source of funds for small and medium size thrifts and banks, I believe that it may be more appropriate for Congress to resolve the broad question of the role of deposit insurance in this era of interest rate deregulation.

The House Committee on Government Operations, Subcommittee on Commerce, Consumer and Monetary Affairs is presently having hearings on this subject and hearings are expected in the Senate in the near future. Accordingly, I urge that final action on the proposed rule on brokered deposits be deferred until Congress has had an opportunity to review this matter fully.

Sincerely,

Alan Cranston

Alan Cranston

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

April 16, 1984

Honorable Alan Cranston
United States Senate
Washington, D.C. 20510

Dear Senator Cranston:

Chairman Gray has asked me to reply to your recent letter requesting that the Federal Home Loan Bank Board ("Bank Board") extend the comment period on the proposed rule on the insurance of brokered deposits (49 Fed. Reg. 2787, January 23, 1984). The comment period on the proposed rule closed on March 8, 1984.

As you know, the rulemaking proceeding began on November 1, 1983, with the joint issuance of an Advance Notice of Proposed Rulemaking (48 Fed. Reg. 50339) by the Federal Deposit Insurance Corporation ("FDIC") and the Bank Board. Two hundred and forty-one comments, on a wide range of issues and questions, were received by the two agencies in response to the Advance Notice. The problem addressed by the proposed rule has been well covered in the general, financial, and trade press. Since the issuance of the proposed rule, the Bank Board alone received over 3,000 comment letters.

As a result of the widespread public comment, we believe that the Board has received more than adequate information concerning the public views of the issues presented and that an extension of the comment period beyond that specified in the proposed rule would serve no useful purpose. While an extension would increase the number of letters to be reviewed by the Board and its staff, it is unlikely that any issues or facts not already aired in the comments received during the original comment period would be received.

Those serious concerns which compelled the Bank Board and the FDIC to issue the proposed rule and to call for public comment are still present. Since the issuance of the proposed rule we have found continued abuses of brokered deposits by insured institutions, including one instance where a supervisory case institution raised over $40 million in brokered deposits, in violation of a supervisory directive prohibiting it from obtaining additional amounts of brokered funds.

The Bank Board has been given responsibility by the Congress to maintain, manage and protect the safety and soundness of the Federal Savings and Loan Insurance Corporation, and is specifically authorized to invoke the rulemaking process as a method to deal with such matters, in the public interest. Therefore, on March 26, 1984, the Bank Board and the FDIC took final action on the proposed rule. A copy of the new regulation is enclosed for your information.

Very truly yours,

Norman H Raiden

Norman H. Raiden
General Counsel

Enclosure

No. 84-141

Date: March 26, 1984

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 330

FEDERAL HOME LOAN BANK BOARD

12 CFR Parts 561 and 564

Brokered Deposits; Limitations on Deposit Insurance

AGENCIES: Federal Deposit Insurance Corporation and Federal Home Loan Bank Board

ACTION: Final rule

SUMMARY: The Federal Deposit Insurance Corporation ("FDIC") and the Federal Home Loan Bank Board ("Board"), as operating head of the Federal Savings and Loan Insurance Corporation ("FSLIC"), have adopted final regulations on deposits brokered by third parties into institutions whose accounts are insured by the FDIC or FSLIC ("insured institutions"). The regulations are intended to address the concern of the two Agencies with the problems arising from brokered funds, particularly in view of the recent decontrol of interest rates paid on deposits by insured institutions. As adopted, the regulations limit insurance coverage afforded to deposits placed with insured institutions by brokers engaged in the business of placing deposits, with certain specified exemptions.

EFFECTIVE DATE: October 1, 1984, with certain exceptions described in sections to be codified at 12 CFR 330.13 and 564.12.

FOR FURTHER INFORMATION CONTACT: Joseph A. DiNuzzo, Senior Attorney, Federal Deposit Insurance Corporation, Legal Division, (202) 389-4171, Room 4136B, 550 17th Street, N.W., Washington, D.C. 20429, or Christopher P. Bolle, Law Clerk, (202) 377-7057, or Robert S. Monheit, (202) 377-6465, Attorney, Federal Home Loan Bank Board, Office of General Counsel, 1700 G Street, N.W., Washington, D.C. 20552.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On November 1, 1983, the FDIC and the Board ("Agencies") issued an Advance Notice of Proposed Rulemaking, soliciting comments on the brokering of deposits of institutions whose accounts are insured by the FDIC or FSLIC ("insured institutions"). 48 FR 50,339 (1983). The Advance Notice set forth the concerns shared by the FDIC and the

Board about deposit brokerage, principally the swift receipt of large volumes of funds by insured institutions from outside their natural market areas irrespective of the institutions' managerial and financial soundness, and the increased costs to the FDIC and the FSLIC in the form of either greater insurance payments or higher assistance expenditures if the institutions are subsequently closed or merged because of insolvency. The Advance Notice posed a series of questions to the public concerning those issues and the possible means of dealing with them.

In January 1984, after reviewing the information received pursuant to the Advance Notice and other relevant data, the FDIC and the Board proposed amendments to their respective regulations governing the insurance coverage to be afforded deposits placed by or through brokers with insured institutions. 49 FR 2787 (1984). The proposal was designed to limit the insurance coverage on deposits placed by or through deposit brokers to $100,000 per insured institution per deposit broker. The term "deposit broker" was defined as any person or entity, other than an insured institution or its employee, engaged in the business of placing or listing for placement deposits of insured institutions. The proposal also limited insurance for deposit accounts established by a trustee or agent pursuant to an agreement to fund a prearranged loan. After careful consideration of the comments received and further analysis of other available information, the Agencies have decided to adopt the proposed amendments, with the modifications discussed below.

OVERVIEW OF COMMENTS RECEIVED

The FDIC received 3,498 comments on the proposed rule. The majority of these comments (2,823) were from individuals, with 281 from banks, 105 from savings and loan associations, 70 from brokers and other financial intermediaries, and 92 from credit unions. The other comments received were submitted by government agencies, local public units, Members of Congress, law firms, private businesses and trade associations.

The Board received 3,403 comments on the proposed rule, 2,776 of which were from individuals, 264 from savings institutions, 41 from commercial banks, and 104 from credit unions. Brokers and other financial intermediaries submitted 23 comments, and 195 letters were received from other entities, including government agencies, Members of Congress, law firms, trade associations and private businesses.

Virtually all the individuals who commented on the proposal identified themselves as customers of deposit brokers and opposed the rule, citing convenience, competitive rates and maturities, and liquidity of brokered funds. A small minority of individuals who commented favored the proposal, noting the negative economic implications of the abuses connected with brokered deposits. Credit union commenters, also identified as deposit brokerage customers, opposed the rule for similar reasons, noting that credit unions do not generally have the resources to place funds themselves in a cost-effective manner.

A slight majority of the banks that expressed an overall opinion about the proposal opposed it on the grounds of cost-effectiveness and the access to national markets provided by brokers. They recommended further supervisory action regarding the use of brokered funds. Banks favoring the proposal asserted that deposit brokerage increases an institution's cost of funds and could increase insurance premiums for all FDIC-insured banks, and causes funds to flow from local communities. The American Bankers Association and the Independent Bankers Association of America (the two major bank trade associations) supported the proposal.

One out of every twelve savings institutions (or 264 out of approximately 3,200 savings institutions) submitted individual comments. A slight majority of comments from individual savings institutions opposed implementation of the regulation as proposed, offering various approaches to ameliorate the problems addressed. Comments in opposition emphasized cost-effectiveness, competition and establishment of a national market, and the use of brokered funds for maturity matching. The National Council of Savings Institutions and the Texas Savings and Loan League also opposed the proposal. Thrifts favoring the rule referred to higher deposit liability costs to all institutions, resulting in higher borrowing costs; their major concern, however, is increased exposure of the deposit insurance funds and resulting increases in insurance premiums. The U.S. League of Savings Associations also favored the rule because of the threat brokered funds pose to the Insurance Fund. All but one of the state savings leagues which commented expressed general support for the proposed rule, although some suggested various modifications. These included the California League of Savings Institutions (California institutions hold sixty-three percent of all brokered deposits in the thrift industry), the New Hampshire Co-operative Savings and Loan League, the New York League of Savings Institutions,the New Jersey Savings League, the Ohio Savings and Loan League, the Florida League of Financial Institutions, the Pennsylvania Association of Savings Institutions, and the West Virginia League of Savings Institutions.

Deposit brokers and other financial intermediaries opposed the rule, which they argued was unfairly directed at them rather than at problems of institution mismanagement. These commenters warned of disruption in the secondary market for certificates of deposit with consequent detrimental effect on individual investors and small and medium-sized institutions, and discrimination in favor of large institutions with the capacity to reach a national customer base. They recommended restricting the application of the rule to funds of "institutional" investors and funds invested in weak institutions, registration of deposit brokers with the Securities and Exchange Commission, and higher insurance premium assessments for institutions engaged in riskier activities.

Thirty-seven members of the United States Congress commented on the proposal; they acknowledged the negative aspects of deposit brokerage but requested that the Agencies defer action until Congress has had the opportunity to act on the matter. The Comptroller of the Currency criticized the proposal and recommended that the Agencies utilize a supervisory approach to the problems engendered by deposit brokerage; he suggested a limitation of $100,000 on the insurance coverage any single depositor could obtain on funds placed through any one broker, irrespective of the number of insured institutions involved. The Antitrust Division of the United States Department of Justice expressed the view that the proposal would cause competitive harm and recommended a more limited approach to the problem. The Comptroller and the Antitrust Division, as well as some other commenters, questioned the statutory authority supporting the restriction on deposit insurance coverage and the effectiveness and enforceability of the proposed approach.

DISCUSSION OF ISSUES RAISED BY COMMENTERS

Statutory Authority

Several commenters expressed the view that the proposed rule would exceed express statutory authority regarding insurance coverage. They asserted a conflict between the proposal and the Congressional objective of protecting investors by insuring all deposits up to an aggregate amount per investor, pointing out that the federal deposit insurance system was intended to safeguard the savings of depositors, increase depositor confidence in financial institutions and promote economic growth through increased availability of credit.

Those commenters favoring the proposed approach frequently asserted that deposit brokerage had resulted in the misuse and exploitation of the deposit insurance funds. They noted that the legislative purpose in creating the federal deposit insurance system was to guarantee the safety of consumers' savings and not to maximize the investment yields of large investors. These commenters believe that deposit brokerage is unjustified and hazardous to the federal deposit insurance system.

The FDIC and the Board agree that insured deposit brokerage is inconsistent with the fundamental and overriding purposes which were meant to be served by the federal deposit insurance system. Deposit insurance was originally intended to establish stability and to promote confidence in the monetary and banking systems by protecting primarily small, relatively unsophisticated depositors in their relationships with banks and savings associations. It was not intended to protect investors seeking the highest yields available in money markets.

With regard to specific statutory authority, the Agencies note that they are clearly empowered to promulgate an insurance-limitation rule pursuant to provisions of the Federal Deposit Insurance Act (12 U.S.C. 1811-1832) and Title IV of the National Housing Act (12 U.S.C. 1724 et seq.) which expressly authorize the promulgation of "legislative" rules clarifying, defining, and limiting the insurance coverage provided, and the promulgation of rules proscribing unsafe or unsound practices. The FDIC and the Board have carefully observed explicit statutory limitations in this area (and, for example, have excluded certain IRA and Keogh accounts from coverage under this rule).

Cost of Funds to Insured Institutions

Insured institutions opposing restrictions to deposit brokerage activities frequently cited substantial savings realizable by obtaining deposits through brokers, and suggested that such cost savings could be passed along to the public. Many commenters view such funds as an inexpensive alternative to direct solicitation, especially for smaller institutions lacking extensive branch networks, and argued that only money-center banks would be capable of attracting lower-cost funds outside the local area.

Financial institution commenters supporting the proposal expressed alarm at the prospect of being subjected to the vagaries of the marketplace through heavy dependence on brokered deposits. Because brokered funds are typically generated outside of the depository institution's retail deposit base, the institution is forced to pay the highest national market rates to attract these funds, leading ultimately to increased costs for all institutions operating in the same retail deposit area. In the view of these commenters, the proposal would eliminate the deposit brokers' retailing of certificates of deposit to the highest bidder and would return the deposits to their deposit base -- the local community --thus containing the cost of raising funds through retail deposits.

The Agencies note that opinion was divided as to the actual effect of the use of brokers on an insured institution's cost of funds. Those who alleged that brokered deposits are less expensive often offered a branch network as the alternative, and did not consider the relative costs of raising funds through other low overhead means such as direct solicitation, advertising and deposit-listing services, none of which would be affected by the new rule.

Investor Convenience

Individual commenters generally praised the convenience of placing deposits in insured institutions through investment brokers. Many commenters stated that use of these third-party intermediaries provided small investors with access to national markets, permitting wider choices of deposit instruments, interest rates and maturities formerly available only to large investors. Commenters also cited the liquidity of brokered CDs facilitated by the active secondary market in these instruments.

The Agencies understand the desire of individual investors to use the most convenient method of obtaining high protected yields. The FDIC, however, does not agree that deposit insurance was ever intended to facilitate shopping by investors for the highest yields available in national money markets, irrespective of the creditworthiness of the borrowing institutions. The Board concurs, and finds that limiting insurance of deposits placed through brokers is not necessarily detrimental to the investor's goal; deposit-listing services, for example, may offer a wider choice than a broker who merely recommends a particular depository. Furthermore, it does not appear unreasonable that investors should choose between accepting a broker's judgment as to the safety of an uninsured investment and doing minimal research to find an insured investment. An investor who believes that only a broker can offer the convenience needed may continue to use such a service, but full deposit insurance will not be provided to that investor.

Capital Markets

Redistribution of funds from "capital rich" to "capital poor" markets was frequently mentioned as a desirable by-product of deposit brokerage. Commenters suggested that this redistribution provided funds for housing and other lending needs in many areas of the country. In addition, many institutions viewed brokered CDs as valuable tools in balancing their assets and liabilities. Several commenters suggested that the prudent use of brokered funds could assist struggling institutions in restructuring their operations, ultimately saving the Insurance Funds from costly assisted mergers or liquidations.

The Agencies have seen no evidence that brokered funds move capital from one area to another in ways that are uniquely helpful to the financial institutions involved or to their depositors and borrowers. Rather, it appears that brokered funds move to the institutions willing to pay the highest rate, wherever located. Other mechanisms can be used to aid institutions in cash-poor areas in raising capital, such as the inter-bank market, advertisements, stock or debt sales, and secondary market activity in loans. In the view of the Board and the FDIC, there is no compelling reason to permit continued brokering of insured deposits to meet these needs when there are other less objectionable means available. Moreover, one comment, indicating that without brokered funds the commenting institution could not even meet its current obligations to pay interest on outstanding instruments, illustrated precisely the kind of dangerous "capital movement" practice the rule is intended to curb. Funds flows should be based on the creditworthiness of the borrowing institution, not simply the rate of interest paid on a federally guaranteed instrument.

Appropriateness of Mechanism Based on Supervisory Concerns

The FDIC and the Board have reviewed their data on banks and savings associations which are involved with deposit brokerage. Indications are that, although brokered deposits at the present time comprise a modest percentage of total domestic deposits, a significantly greater proportion of poorly-rated institutions use brokered deposits than highly-rated institutions. The 77 commercial banks that failed in 1982 and 1983 had substantial brokered deposits, constituting, on the average, 16 percent of total deposits. In three instances, brokered deposits equalled more than 60 percent of the failed bank's total deposits. In 19 other cases, these deposits equalled between 20 and 50 percent of the failed bank's deposits. As of mid-March 1984, 13 commercial banks had failed in 1984; seven of these held brokered deposits ranging as high as 53 percent of total deposits.

In savings associations insured by the FSLIC, brokered deposits totaled approximately $3 billion in January, 1982, and had increased tenfold to almost $30 billion by December, 1983. Moreover, there has been a significant correlation between associations which use brokered deposits and those which have supervisory problems. In 1982 and 1983, more than half of the insured institutions that were closed by the FSLIC had brokered funds in excess of one-third of their deposits. Almost half of the institutions with a net worth below acceptable levels have brokered deposits in excess of 20 percent of their total deposits. For example, in one case, an institution had $240 million in brokered deposits, representing 90 percent of its deposit base. Another problem association used brokered deposits to increase its assets by over 2,500 percent, with brokered deposits representing 70 percent of its total liabilities. In 1983, only 670 of the approxmiately 3,200 FSLIC-member institutions reported any use of brokered deposits. The use of brokered deposits is even more highly concentrated than that figure indicates: 94 percent of all brokered deposits are concentrated in the 369 FSLIC-insured institutions (approximately one-tenth of the industry) that hold brokered deposits in excess of 5 percent of total deposits, and of these, 145 are troubled institutions. The FDIC and the Board are continuing to collect information on deposit brokerage and, as discussed below, are monitoring the use of brokered funds by problem institutions.

Commenters have questioned these figures by suggesting that a large portion of the brokered funds of recently failed banks and thrifts are in fact uninsured deposits of institutional investors. Cases handled recently indicate that quite the opposite is true, and suggest that, since the occurrence of several highly publicized depository institution failures, the great majority of investors have sought full insurance coverage of deposits.

In addition to their concern about the effects of deposit brokerage on already troubled institutions, the FDIC and the Board are concerned about the potential which exists for the abuse of brokered funds by insured institutions generally. There are a number of reasons why currently sound institutions might succumb to the opportunity to swiftly and dramatically increase their deposit size through massive infusions of brokered funds. These funds, which are often received in large amounts at high cost, must be invested quickly for purposes of economic efficiency. The Agencies' experience has shown that the speed required may not allow for the usual care to be taken in appraisals and credit checks relative to investments. Moreover, the need to offer a high rate of return to attract brokered funds may require institutions to take greater investment risks, a factor often aggravated where the broker or associated parties suggest or stipulate particular uses for the funds. Healthy institutions may become problem cases very quickly through a very few transactions of this sort. One institution, for example, used brokered deposits to quadruple its asset size in a year. Although this institution was healthy at the outset of the year, the brokered funds were used to invest in highly speculative commercial loans at a pace that precluded the association from using adequate underwriting procedures, so that it is now a problem for the FSLIC. In another transaction, brokered funds were deployed to fund transactions where the value of security properties were artificially inflated to levels bearing no resemblance to real value as security for loans.

Although only a small percentage of institutions currently engage in the brokered deposits market, the Board believes the expanded use of such funds could have a significant effect on the entire insured depository industry. If brokered deposits grew into a dominant source of funds, it is possible that high national market rates would become a "floor" even in remote areas, and therefore, as a commenter observed, raise the cost of home loans and other consumer borrowing, or force institutions into making more speculative investments in order to cover the cost of funds. In addition to increasing the cost of money, such a situation also could result in a standardization of terms and the imposition of minimum amounts of deposits.

The Board also is concerned that the continued use of brokered funds could, through the use of nationwide brokers, draw institutions away from direct contact with their local communities and that the "local nexus" could be lost. Particularly troublesome is the possibility that, if institutions rely heavily on brokered funds rather than the local savings base, they will feel less need to respond to the housing and credit needs of their local communities.

Several commenters suggested that the Agencies adopt a differential approach to the treatment of brokered funds. It was suggested that the funds be divided into uninsured accounts, insured individual accounts and insured institutional accounts. Only the latter would be regulated, since commenters asserted that these accounts represented the greatest risk to the Insurance Funds because they frequently are placed by brokers not registered with the SEC and do not receive the prudent analysis of risk enjoyed by insured individual depositors.

This approach is discussed in more detail in the section describing alternatives considered. In brief, however, the Agencies see no reason to differentiate between these two types of deposit: both sources of funds are placed by brokers and result in large sums moving rapidly among institutions.

A number of commenters questioned the enforceability and effectiveness of the proposed approach. They expressed the belief that weak institutions could easily circumvent the proposed restrictions by advertising directly in nationally circulated newspapers or merely by bringing the brokerage function in-house. Further, the use of brokers could be concealed from deposit insurers, encouraging troubled institutions to use subterfuge as to the origin of deposits. Finally, these commenters noted that neither the Agencies nor the depository institution could easily distinguish between brokered deposits placed by individuals directly (although on the advice of a deposit-listing service) and other more readily ascertainable types of brokered deposits, thus making enforcement even more difficult.

The FDIC and the Board believe that institutions will comply with the final rule, and that attempts at evasion would be discovered in the course of regularly scheduled examinations through detection of account patterns. In addition, institutions probably would be unwilling to participate in such arrangements because of the uncertainty of ultimate insurability. Finally, the Agencies do not believe brokers would participate in such activities because the potential discovery of evasion could result in significant broker liability.

Consideration of Alternative Approaches

Many commenters suggested alternatives to the approach taken by the proposed regulation.

1. Focus on Institutional Accounts

Several commenters recommended that a distinction be made between institutional and individual investors, and insured and uninsured brokered funds. They allege that insured institutional deposits, comprising less than 10 percent of the market, in which deposits are broken into $100,000 lots to achieve full insurance coverage, pose the most risk to the Insurance Funds because they generally are short-term and are largely placed by unregulated money brokers without the benefit of credit analysis.

The FDIC and the Board believe that this approach would not accomplish their objectives, and would not address many of the problems inherent in brokered funds. Even if the characterization of institutional insured brokered deposits is accurate, it does not argue strongly for a different approach; an account with a longer maturity does not carry the imminent threat of nonrenewal, but is nonetheless subject to the same reinvestment problems as a shorter-term account. Furthermore, the Agencies have not been presented with convincing evidence that there are significant differences between brokers of institutional funds and brokers of individuals' deposits; there are brokers of institutional funds who are registered, use credit analysis, and carefully select insured banks and thrifts for their clients, while brokers for individual investors have not been immune from placing deposits in troubled institutions. Assuming that a difference does exist, a rule allowing continued insurance of individual investors would merely invite institutional brokers to enter the individual investor market and to continue their allegedly inadequate practices. Moreover, the growth of the money market mutual fund industry indicates that insured third-party deposit brokerage, even if limited to the deposits of individuals, would continue to proliferate and present problems similar to those presented today.

2. Focus on Troubled Institutions Only

Commenters suggested limiting application of the regulation to institutions which fall below required levels of net worth or pose other supervisory problems.

The FDIC and the Board already have taken certain actions in this area and are proposing additional steps. The FDIC currently requires all of its regulated institutions subject to an enforcement action or party to a memorandum of understanding with the FDIC to notify the FDIC before the institution's proportion of brokered deposits to total deposits exceeds five percent. The Board has issued a supervisory directive, dated October 26, 1983, requiring any insured institution failing to meet its regulatory net-worth requirement to give ten days' notice prior to increasing its use of brokered funds to a level above five percent of total deposits, along with information indicating the sources and expected uses of the funds. In addition, the Board today is adopting a temporary regulation limiting to five percent of assets the amount of brokered deposits that may be taken in by an institution with net worth below a certain level; that regulation is intended to prevent unsafe practices by thinly-capitalized institutions which might seek to increase unreasonably their levels of insured brokered deposits prior to the October 1 effective date of the regulation set forth in this Resolution. See ____FR ________

However, focusing only on the access of particularly vulnerable banks and thrifts to brokered funds would not prevent abuse by such institutions that were not of supervisory concern prior to their last examination, nor would it effectively protect the FDIC and the FSLIC from increased liabilities stemming from the actions of desperate bank or thrift managers willing to violate regulations in a gamble to use brokered deposits to stave off failure. In one case, a State-chartered, FSLIC-insured thrift institution raised over $40 million in brokered deposits in two days and used these funds to finance a transaction in direct violation of a State cease-and-desist order; while the State regulatory authority may take disciplinary action against the management of that institution, the cost to the FSLIC to resolve the case will nonetheless increase significantly.

The insurance-limitation rule will be "self-implementing" and thus very effective, without imposing substantial regulatory or reporting requirements, and it will encourage the market to discipline investors and recipients of brokered deposits. The rule also reduces the risk to the FDIC and the FSLIC from potential increased liabilities incurred by management in supervisory situations.

3. Limit Deposit Growth

Other comments suggested that limitations be placed on the rate of all deposit growth of institutions, based upon varying percentages of net worth, assets, liabilities or other determinants.

The FDIC and the Board find the suggestions to limit or monitor the deposit growth of all insured banks and thrifts to be a more burdensome regulatory approach. The FDIC believes that it is not apparent how any particular limit could be arrived at or supported. Moreover, any limit, such as 15 percent of deposits, which has been suggested by some, would be excessive for poorly operated institutions and unduly restrictive for institutions with strong management and financial ratios. The insurance-limitation approach allows each institution to utilize brokered funds to the extent it can attract them based on its own creditworthiness. The Board concurs, and notes that a rule effectively limiting but not over-regulating deposit growth could be quite complex; such an approach could impose significant regulatory burdens on types of growth that occur more slowly and therefore are of less regulatory concern than the use of brokered funds.

4. Registration of Brokers

A significant number of commenters recommended that all deposit brokers be required to register with the Securities and Exchange Commission ("SEC").

The Agencies find that requiring registration of brokers with the SEC would be a meaningless exercise so long as their customers' deposits were fully insured by the FDIC or the FSLIC, because there would be no market discipline in the placement of deposits. In this connection, the Agencies have found that SEC-registered brokers have not been immune from placing brokered deposits into troubled banks and thrifts; registering additional brokers will not provide additional assurances. Further, SEC registration requirements would not protect the FDIC or FSLIC funds, because they are not oriented toward the safety and soundness of insured institutions or the deposit insurance funds.

5. Variable-rate Insurance Premiums

A number of commenters recommended that deposit insurance premiums either be increased or varied to reflect the increased risk factor created by deposit brokerage. The FDIC believes risk-related deposit insurance premiums should be implemented and has requested Congress to enact enabling legislation. Risk-related premiums, however, would not be a panacea. Assessment of higher premiums might discourage the acquisition of troubled banks or thrifts, or increase the amount of federal financial assistance required in connection with supervisory solutions for such institutions. A variable insurance premium, even if authorized, would not necessarily solve the problems addressed by the final rule. Such a premium structure, if based upon the level of brokered funds, could also invite circumvention through manipulation of brokered-deposit levels during phases of reporting periods. Consistent with the goals of deregulation, the insurance-limitation rule will act to deter investors from placing deposits in what the market determines to be high-risk institutions, rather than trying to deter such institutions from making investments that the regulators believe are high-risk. Lastly, the variable-premium suggestion erroneously assumes that the Congress intended insured banks and thrifts to pay higher premiums in order to permit deposit brokers to continue to profit through the marketing of FDIC- or FSLIC-insured products.

6. Increased Supervisory Efforts

A substantial number of commenters recommended increased examinations, reporting requirements and other forms of supervision to regulate the investment practices of institutions utilizing brokered funds. These alternatives could be applied to all institutions, or only to those experiencing net-worth deficiencies or other supervisory problems, or could be tied to a scale depending on the institution's rating, net worth, capital, or any other measure of economic viability. The Agencies have considered these alternatives, but believe that they would require constant monitoring, and would only serve to increase the regulatory burden on depository institutions and the supervisory role of the Agencies. This is contrary to the spirit of deregulation and would necessitate an increase in the staff and costs of the Agencies, while doing little to protect the Insurance Funds from institutions unconcerned with the consequences of regulatory violation. Also, the ability of institutions to raise millions of dollars in brokered funds in a very short period would render ineffective any provision for additional monitoring or reporting, because the damage would already have been incurred.

7. Prohibition or Limitation on Receipt of Brokered Funds

The Agencies also considered a blanket prohibition on the use of brokered deposits, but rejected it because it would totally eliminate the benefits to insured institutions of brokered deposits. A stringent limitation would have much the same effect, and a generous percentage would allow continuation of current abuses. Limiting the insurance coverage of brokered deposits, on the other hand, will not defeat the liquidity benefits of brokered deposits for well-run institutions. Such deposits will still be obtainable, but without the insurance guaranty. Investment decisions will have to be made on the basis of analysis of the strength or weakness of the involved depository institution, and not on the insurance feature of the deposit. Inasmuch as a number of deposit-broker comments have indicated that this process has already been established for their individual investor depositors, the new rule should not prove unduly burdensome.

After careful consideration of all of the alternatives, the FDIC and the Board have found the insurance-limitation approach to be the most effective method for addressing the problems presented by the growth of brokered deposits in a deregulated environment. Further, the final rule achieves the Agencies' intended purposes by using market discipline rather than by imposing burdensome regulatory and reporting requirements. The alternatives suggested are, in contrast, ineffective and/or overly burdensome, and all assume that the Congress intended deposit brokers to benefit through the marketing of FDIC- or FSLIC-insured products without being directly subject to regulations intended to ensure the soundness of the Insurance Funds.

EXPLANATION OF THE RULE

The Definition of Deposit Broker

Many commenters suggested modifications to the definition of the term "deposit broker" contained in the proposal. Most recommended exemptions of certain groups from the definition, such as beneficial owners of IRA, Keogh and qualified pension and profit-sharing plans and part-time investment advisers/agents, typically affiliated with small, community-based depository institutions. Other commenters urged a broader definition to encompass persons or entities, such as real estate and insurance agents, who solicit deposits generally for insured depository institutions lacking extensive branch networks. Other commenters, responding to a question posed in the proposal, recommended inclusion of insured institution subsidiary/joint ventures within the scope of the definition of deposit broker.

The final rule limits the insurance coverage of funds placed by or through a "deposit broker" to $100,000 per broker per insured institution. This differs from the current FDIC and Board regulations which, if certain requirements are met, deem the customer of the deposit broker to be the "depositor" or "member." "Deposit broker" is defined as any person or entity engaged in the business of placing deposits for others, or of placing funds in accounts to be sold to others, and an agent or trustee who establishes a deposit or member account in connection with an agreement with the institution to use the proceeds in the account to fund a prearranged loan.

The definition of "deposit broker" includes not only deposit brokerage arrangements where the broker is the holder of an account for a number of principals, but also where the broker directs or otherwise facilitates the transfer of funds of depositors to an institution without itself becoming a holder of an account. Except for the situations noted below, the definition includes anyone in the business of placing funds in an account for a third party, whether or not the deposit broker is the legal or beneficial owner of the account, and whether or not the placement of funds in accounts is that person's primary business. The term "deposit broker" excludes a depository institution which generates deposits for itself, but includes depository institutions generating deposits for other depository institutions. Also, the definition includes subsidiaries, service corporations or affiliates which place funds with related depository institutions. Likewise, no exception is made for depository institutions either owned by or affiliated with securities firms.

The definition does not include employees of depository institutions. Because the agencies are concerned, however, that too broad a definition of "employee" would lead to circumvention of the intent behind the proposed amendments, the rule adopts the proposed definition of an "employee" of an institution as a person: (1) who is employed exclusively by the institution for which he or she is soliciting deposits; (2) whose primary compensation is in the form of a salary; (3) who does not share his or her compensation with a deposit broker; and (4) whose office space or place of business is used exclusively for the benefit of his or her institution/employer.

The definition of "deposit broker" does not generally include trust departments of insured institutions; however, where a deposit broker places deposits through a trust department, all funds placed by that deposit broker will be insured only up to $100,000. Also, a trust department would be deemed a deposit broker in connection with trusts established primarily for the purpose of placing funds with insured institutions.

The definition of "deposit broker" in the proposed rule included all deposit-listing services. In light of the comments and other available information, the Agencies have concluded that it would be infeasible to identify deposits that are placed by reference to listing services that did not actually facilitate the placement of funds with insured institutions. In addition, where the only function of a deposit listing service is to provide information on the availability and terms of accounts, the Agencies believe that the service's minimal participation in the placement process does not merit treatment as a deposit broker. Therefore, the Agencies have specifically excluded from the definition of "deposit broker" any deposit-listing service that does not receive a commission for the number or amount of deposits placed as the result of its service, if the service provided is limited to the collection and transmission of information on the accounts available, and the customer, rather than the deposit-lister or its agent, transmits the funds to the insured institution.

The FDIC and the Board do not intend to disturb traditional deposit relationships. Accounts held by agents will remain insured up to $100,000 per principal, provided that the agent is not engaged in the business of placing deposits. Thus, arrangements such as real estate agent accounts and attorney escrow accounts will not be affected by the amendments because such accounts are held for a purpose incidental to the ordinary business activities of the agent.

Some commenters expressed concern that the rule as proposed could limit the insurance coverage available to trustees under the current regulations. While the agencies do not intend to alter the coverage currently available to traditional trust arrangements, they are concerned that a blanket exemption of all trustees from the definition of deposit broker could lead to substantial circumvention of the rule through various trust-type mechanisms. The final rule therefore exempts trustees from the definition of "deposit broker" provided that the trust in question is not used primarily for the purpose of placing funds in insured institutions. This will preserve the current insurance coverage for trusts while limiting the usefulness of trusts as devices to circumvent the rule.

The insurance coverage currently available to deposits held in connection with pension funds and other employee benefit plans will not be affected by the rule unless such deposits are placed by or through a deposit broker. In addition, trustees and custodians of IRA and Keogh accounts will not be deemed to be deposit brokers. Likewise, the insurance coverage of accounts of public units will not be affected, provided that a deposit broker is not employed to place the funds.

In situations where deposits of pension or other employee-benefit plans are placed by plan administrators or investment advisors, such deposits will not be deemed "placed by or through a deposit broker" as long as such plan administrator or investment advisor plays a managerial role relative to the applicable pension or employee-benefit plan. The reason for this exception is to prevent undue disruption in the pension-fund industry and to further the intent of the Employee Retirement Income Security Act of 1974 (29 U.S.C. §§ 1001-1462).

Negotiable Certificates of Deposit

Under the current regulations, for insurance purposes, the "depositor" of a negotiable or bearer-form deposit is the person holding the deposit on the date the institution is closed because of insolvency, 12 CFR 330.11 and 570.11. The Agencies were concerned that such deposits might be used to subvert the intent of the proposed amendments, and requested comments on amendments to current rules which would address this potential problem. After careful consideration of comments received in this regard, the Agencies have determined that it is not appropriate at this time to impose any special restrictions on negotiable certificates. The FDIC and the Board will monitor this area and will take appropriate action in the future if necessary.

Effective Date

The Agencies received numerous comments with regard to the effective date of the regulation. Some commenters endorsed an earlier effective date, while others supported a more gradual phase-out of insurance for brokered deposits. Still others recommended immediate emphasis on existing supervisory remedies for troubled institutions in conjunction with continued study of the issue, including deferral to legislative initiatives. The Agencies also received a petition for revision of this rulemaking process and request for an extension of the comment period from an owner of a listing service; the Board and the FDIC are taking this opportunity to deny that petition and request because they believe it essential that the issue of brokered funds abuse be promptly addressed, particularly in view of the recent decontrol of interest rates. The Agencies believe that the public has had ample time, during the comment periods provided for in the Advance Notice and the Proposal, to express its views on the issues raised by deposit brokerage and the means of addressing those issues.

The effective date for the final rule, as stated in the proposal, is October 1, 1984. Thus, except for the situations noted below, any brokered deposits placed or renewed on or after October 1, 1984, will be subject to the new regulations on insurance coverage. All deposits with insured institutions prior to October 1, 1984, irrespective of whether they would qualify as brokered deposits under the final rule, will be insured until their maturity dates under the regulations predating the final rule. The purposes of the delayed effective date and continuation of insurance on accounts existing before that date are: (1) to fulfill depositors' expectations as to terms and conditions of existing deposits which, because of the term remaining, could not be withdrawn without imposition of a penalty for early withdrawal; (2) to allow institutions relying heavily on brokered deposits time to adjust their deposit structures; and (3) to provide for an orderly adjustment of funding techniques. Based on their examination of the problems facing institutions in adjusting to the effects of the rule, and their analysis of comments received, the

Agencies have concluded that an effective date of October 1, 1984, provides enough time for institutions and the purchasers of brokered deposits to adjust their business practices.

Questions arose in the comments about the treatment to be afforded money market deposit accounts ("MMDAs") and other accounts without existing maturities placed before October 1, 1984. The issue was raised whether such accounts placed by or through a broker prior to the effective date of the final rule would be insured under the pre-existing regulations until the funds are withdrawn or whether the insurance coverage on those accounts would change as of the effective date of the rule. Upon consideration of the comments, the Agencies have decided that funds in such accounts placed by brokers with insured institutions before October 1, 1984, will be insured under the insurance coverage rules predating the final rule until November 30, 1984. This treatment allows for a two-month period after the general effective date of the final rule in which holders of such accounts may adjust their deposit-placement practices. Deposits with no fixed maturities placed by brokers on or after October 1, 1984, will be subject to the final rule and its general effective date of October 1, 1984.

Certificates of deposit held in trust for bondholders under "loans-to-lenders" or industrial development bond ("IDB") programs are covered by the final rule. These programs entail a transaction where the proceeds of an IDB issuance are placed with an insured institution, in exchange for a certificate of deposit, to fund a designated project. Because of the trust arrangement involved, under the Agencies' current insurance coverage rules each bondholder owns an insured interest in the deposit up to $100,000 and the deposit, therefore, may be fully insured by either the FDIC or the FSLIC. The final rule will limit the insurance coverage of such deposits to $100,000 inasmuch as it specifically defines a trustee in this type of transaction to be a "deposit broker." Thus, beginning October 1, 1984, IDB programs will no longer be buttressed by full deposit insurance. A question arises, however, about existing IDB programs in which the deposit in question has a term shorter than the period of the underlying loan, as opposed to the date of the maturity of the underlying bond. If such existing deposits are deemed to be placed or renewed after October 1, 1984, under the final rule, they will be subject to the new regulations and will therefore be ineligible for multiple insurance coverage. Such a result would trigger acceleration of the maturity dates of the underlying bonds, an event which could result in the bankruptcy of the project and severe liquidity problems for the involved depository institution. In order to avoid this undue hardship, and because of the mandatory nature of the rollover provisions in the bond indentures, the Agencies believe that the maturity dates of such deposits should be deemed to be those of the bonds they secure. Therefore, the final rule provides that deposits issued by an institution to a trustee who is a "deposit broker" with respect to such certificates under either § 330.0(b)(2) or § 561.2a(a)(2) shall not be deemed to be renewed, for purposes of the regulation, unless such renewal is discretionary. This exception will apply only to IDB transactions entered into prior to October 1, 1984.

As already noted, brokered deposits placed or renewed on or after October 1, 1984, will be subject to the restrictive insurance coverage provisions of the final rule. Upon considering the many comments on this issue and analyzing other available data, the Agencies believe it is necessary to safeguard against liquidity problems for insured institutions that have relied heavily in the recent past on brokered deposits as a source of funding. Thus, the final rule provides that brokered deposits held at insured institutions on the date the final rule is adopted by the Agencies may be renewed one or more times by the depositor within a period of two years after the effective date of the final rule (up to October 1, 1986) and continue to qualify for deposit insurance under the regulations predating the final rule until their first maturity after October 1, 1986. However, such deposits may not be renewed for a dollar amount greater than their original denomination, and must be held by the owners in their individual capacities. Deposits held prior to the date of adoption of the final rule (March 26, 1984) in custodial or trust capacities by or through deposit brokers may become eligible for this "rollover" exception only if, by June 30, 1984, the institution is provided with the names and ownership interests of the parties for whom such deposits are maintained. The resulting insurance coverage will then apply only to the owner so identified.

Final Regulatory Flexibility Analysis

Pursuant to Section 3 of the Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164 (Sept. 19, 1980), the FDIC and the Board are providing the following regulatory flexibility analysis:

1. Reasons, objectives, and legal bases underlying the rules. These elements have been incorporated elsewhere in the supplementary information regarding the rule.

2. Small entities to which the rules apply. The rules apply to insured institutions.

3. Impact of the rules on small institutions. As brokered deposits do not yet constitute a significant portion of total deposits of most insured institutions, the rules will not have a significant impact on a substantial number of small entities.

4. Overlapping or conflicting federal rules. There are no federal rules that duplicate, overlap, or conflict with this rule.

5. Alternatives to the rules. The rule limits federal deposit insurance on brokered deposits. Other alternatives considered, such as increased monitoring and approval mechanisms and blanket prohibitions on brokered deposits, would be more burdensome to the regulatees or would eliminate the benefits of a regulated activity, including availability of liquidity.

LISTS OF SUBJECTS

12 CFR Part 330

Bank deposit insurance, Banks, banking, Federal Deposit Insurance Corporation.

12 CFR Parts 561 and 564

Bank deposit insurance, Banks, banking, Federal Home Loan Bank Board, Federal Savings and Loan Insurance Corporation, Savings and Loan associations.

Accordingly, the FDIC hereby amends Part 330 of Title 12 of the CFR and the Board hereby amends Parts 561 and 564 of Title 12 of the CFR, as set forth below.

Part 330 - Clarification and Definition of Deposit Insurance Coverage

1. The authority citation for Part 330 is as follows:

Authority: 12 U.S.C. 1813, 1817, 1819, 1821, 1822.

2. Section 330.0 is hereby revised as follows:

§ 330.0 Definitions.

(a) For the purpose of this Part 330, the term "insured bank" includes an insured branch of a foreign bank.

(b) Except as provided in paragraph (c) of this section, the term "deposit broker" includes: (1) any person engaged in the business of placing funds, or facilitating the placement of funds, of third parties with insured banks or the business of placing funds with insured banks for the purpose of selling interests in those deposits to third parties; and (2) an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured bank to use the proceeds of the account to fund a prearranged loan.

(c) The term "deposit broker" shall not include the following: (1) an insured bank, with respect to funds placed with that bank; (2) an employee of an insured bank, with respect to funds placed with his or her employer/bank; (3) a trust department of an insured bank or of an institution insured by the Federal Savings and Loan Insurance Corporation, provided that the trust in question has not been established for the primary purpose of placing funds with insured depository institutions; (4) the trustee of a pension or other employee benefit plan, with respect to funds of the plan; (5) a person acting as a plan administrator or an investment adviser in connection with a pension plan or other employee benefit plan provided that that person is performing managerial functions with respect to the plan; (6) the trustee of a testamentary account under section 330.3 of this Part; (7) the trustee of an irrevocable trust (other than one described in paragraph (b)(2) of this section), as long as the trust in question has not been established for the primary purpose of placing funds with insured depository institutions; (8) a trustee or custodian of a pension or profit-sharing plan qualified under section 401(d) or 408(a) of the Internal Revenue Code of 1954, as amended; (9) an agent or nominee whose primary purpose is not the placement of funds with depository institutions.

(d) The term "employee," for purposes of this section only, includes only an employee: (1) who is employed exclusively by the insured bank for which he or she is soliciting deposits; (2) whose compensation is primarily in the form of a salary; (3) who does not share his or her compensation with a deposit broker; and (4) whose office space or place of business is used exclusively for the benefit of his or her insured bank/employer.

(e) For purposes of this section only, the term "business of placing funds or facilitating the placement of funds" shall not include deposit listing services where: (1) the person or entity listing the deposit is compensated only by means of a subscription fee which is not calculated on the basis of the number or dollar amount of deposits placed as the result of information provided by such service; (2) the service provided is limited to the gathering and transmission of information concerning the availability of deposits; and (3) any funds to be invested in deposit accounts are remitted directly by the depositor to the insured bank and not, directly or indirectly, through the person or entity providing the listing service.

3. Section 330.2 is hereby revised as follows:

§ 330.2 Individual accounts.

Funds owned by an individual (or by the community between husband and wife of which the individual is a member) and deposited into one or more deposit accounts in his or her own name shall be insured up to $100,000 in the aggregate.

4. Section 330.10 is hereby revised as follows:

§ 330.10 Trust Accounts.

All trust interests for the same beneficiary deposited into deposit accounts established pursuant to valid trust agreements created by the same settlor (grantor) shall be added together and insured up to $100,000 in the aggregate, except time and savings deposits of the same beneficiary which qualify as pension or profit-sharing plans under section 401(d) or 408(a) of the Internal Revenue Code of 1954, as amended. The vested and ascertainable interest (excluding any remainder interest) of each beneficial owner in a time or savings deposit established under either of the above sections, shall be added together and insured to an additional $100,000 maximum for each beneficial owner, notwithstanding the insurance provided in this section to other types of deposit accounts. Except where the trustee is a deposit broker, the insurance of such trust interests shall be separate from that afforded deposit accounts of the trustee of such trust funds or the settlor or beneficiary of such trust arrangement.

5. Section 330.13 is hereby added as follows:

§330.13 Accounts held by or established through intermediaries.

(a) Except as provided in paragraph (b) of this section, funds owned by a principal and deposited into one or more deposit accounts in the name or names of agents or nominees shall be added to any individual accounts of the principal and insured up to $100,000 in the aggregate.

(b) Notwithstanding any other provision of this part, funds deposited into one or more deposit accounts by or through a deposit broker shall be added to any other deposits placed by or through that deposit broker and insured up to $100,000 in the aggregate. This subsection shall apply to all accounts opened, added to, or renewed on or after October 1, 1984, except that it shall not apply until:

(1) either October 1, 1986, or the maturity date of the deposit account, whichever is later, with respect to renewals of all time deposits in existence on March 26, 1984, provided that: (i) only the

interests of persons in such accounts as of March 26, 1984, shall be recognized for purposes of insurance coverage; and (ii) the identities and interests of those beneficial owners are reflected on the books and records of the bank by June 30, 1984;

(2) November 30, 1984, with respect to deposit accounts which have no specified maturity date; and

(3) the maturity date of the corresponding loan with respect to renewals of deposits established before October 1, 1984, by a person who is a deposit broker under section 330.0(b)(2) of this part, only if renewals of such deposits are mandatory under the underlying account agreement.

(c) Funds held by a guardian, custodian or conservator for the benefit of a ward or for the benefit of a minor under a Uniform Gifts to Minors Act and deposited into one or more accounts in the name of the guardian, custodian or conservator shall be added to any individual accounts of the ward or minor and insured up to $100,000 in the aggregate.

SUBCHAPTER D - FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

Part 561 - DEFINITIONS.

1. The authority citation for Part 561 is as follows:

Authority: 12 U.S.C. 1724, 1725, 1726, 1728, 1730.

2. Add new §561.2a, as follows:

§ 561.2a Definition of "deposit broker."

(a) Except as provided in paragraph (b) of this section, the term "deposit broker" includes: (1) any person engaged in the business of placing funds, or facilitating the placement of funds, of third parties in accounts issued by an insured institution or the business of placing funds in accounts issued by insured institutions for the purpose of selling interests in such accounts to third parties; (2) an agent or trustee who establishes an account to facilitate a business arrangement with the institution to use the proceeds of the account to fund a prearranged loan.

(b) The term "deposit broker" does not include the following: (1) an insured institution, with respect to accounts issued by that institution; (2) an employee of an insured institution, with respect to accounts issued by his or her employer; and (3) a trust department of a bank, the accounts of which are insured by the Federal Deposit Insurance Corporation, or of an insured institution, provided that the trust in question has not been established for the primary purpose of placing funds in accounts issued by insured depository institutions; (4) the trustee of a pension or other employee benefit plan, with respect to funds of the plan; (5) a person acting as a plan administrator or an investment adviser in connection with a pension or other employee benefit plan, provided that that person is performing managerial functions with respect to the plan; (6) the trustee of a testamentary account; (7) the trustee of an irrevocable express trust (other than one described in paragraph (a)(2) of this section), provided that the trust in question has not been established and is not being used primarily for the purpose of placing funds in accounts issued by insured institutions; (8) the trustee or custodian of a pension or profit-sharing plan which qualifies under sections 401(d) or 408(a) of the Internal Revenue Code of 1954 as amended; and .(9) an agent or custodian, provided that the primary function of the relationship pursuant to which the funds are invested is not investment of funds in insured accounts.

(c) The term "employee," for purposes of this section only, includes only an employee: (1) who is employed exclusively by the institution for which he or she is soliciting deposits; (2) whose compensation is primarily in the form of a salary; (3) who does not share his or her compensation with a deposit broker; and (4) whose office space or place of business is used exclusively for the benefit of his or her institution/employer.

(d) For purposes of this section, the term "business of placing funds or facilitating the placement of funds" does not include the provision of deposit-listing services where (1) the person or entity providing the service is compensated only by means of a subscription fee which is not calculated on basis of the number or dollar amount of accounts placed as a result of information provided by such service; (2) the service provided is limited to the gathering and transmission of information concerning availability of accounts; and (3) any funds to be invested in accounts are transmitted directly to the insured institution by the depositor and not, directly or indirectly, through the person or entity providing the listing service.

PART 564 - SETTLEMENT OF INSURANCE

3. The authority citation for Part 564 is as follows:

Authority: 12 U.S.C. 1724, 1725, 1726, 1728, 1730.

5. Revise § 564.3 as follows:

§ 564.3 Individual accounts.

Funds owned by an individual (or by the husband-wife community of which the individual is a member) and invested in one or more accounts in his or her own name shall be insured up to $100,000 in the aggregate.

6. Amend § 564.10 adding a sentence at the end thereof, as follows:

§ 564.10 Trust accounts and IRA and Keogh accounts.

. . . Except where the trustee is a deposit broker, the insurance of such trust interests shall be separate from that afforded deposit accounts of the trustee of such trust funds or the settlor or beneficiary of such trust arrangement.

7. Add § 564.12, as follows:

§ 564.12 Accounts held by or established through intermediaries.

(a) Except as provided in paragraph (b) of this section, funds owned by a principal and invested in one or more accounts in the names of agents or nominees shall be added to any individual accounts held directly by the principal, and insured up to $100,000 in the aggregate.

(b) Notwithstanding any other provision of this Part, funds invested in one or more accounts by or through a deposit broker shall be added to any other deposits placed by or through that deposit broker and insured up to $100,000 in the aggregate. This paragraph shall apply to all accounts opened, funds placed in existing accounts, and renewals of existing accounts, where such opening, placement, or renewal occurs on or after October 1, 1984, except that it shall not apply until:

(1) either October 1, 1986, or the maturity date of the account, whichever is later, with respect to renewals of time deposits in existence on March 26, 1984, provided that: (i) only interests of persons in such accounts as of March 26, 1984, will be recognized for purposes of insurance coverage, and (ii) the identities and interests of such beneficial owners are reflected on the records of the insured institution by June 30, 1984;

(2) November 30, 1984, with respect to accounts which have no specified maturity date; and

(3) the maturity date of the corresponding loan, with respect to renewals of accounts established prior to October 1, 1984, and held by a person who is, with respect to such accounts, a deposit broker under § 561.2a(a)(2), only if such renewal is mandatory under the terms of the account agreement or trust agreement governing the rights and obligations of the trustee or agent.

(c) A loan servicer who receives loan payments and places or maintains such payments in an insured institution prior to remittance to the lender or other parties entitled to the funds shall, for insurance-of-accounts purposes, be considered an agent of each borrower.

(d) Funds held by a guardian, custodian, or conservator for the benefit of a ward or a minor under a Uniform Gifts to Minors Act, and invested in one or more accounts in the name of the guardian, custodian, or conservator, shall be added to any individual accounts of the ward or minor and insured up to $100,000 in the aggregate.

By Order of the Board of Directors, March 26, 1984

FEDERAL DEPOSIT INSURANCE CORPORATION

Hoyle L. Robinson
Hoyle L. Robinson
Executive Secretary

By Order of the Board, March 26, 1984

FEDERAL HOME LOAN BANK BOARD

John F. Ghizzoni
John F. Ghizzoni
Assistant Secretary to the Board

Senator CRANSTON. I'm not suggesting this approach without serious understanding of the impact failing institutions may have on the insurance fund, but I believe there is enough supervisory authority now to stop the small percentage of institutions who are abusing brokered deposits and it seems to me that you should be closely monitoring them to prevent the activity from happening.

Indeed, from 1959 until April 1982, the Federal Home Loan Bank Board had a regulation on brokered deposits that set up a percent of asset limitations. The prior chairman in 1982, for reasons that are not clear to me, revoked this regulation.

Could you provide some information to this committee on why that was done and information on how effective that rule was? I'd appreciate that.

Mr. GRAY. Yes. Well, that rule was in effect for many years, I believe going back to the 1960's. I believe the reason that an alternative course of action was taken in the spring of 1982 was because at that time the depository institutions in our country did not have a competitive instrument with which to compete with the money market mutual funds which at the time were siphoning out funds by the billions of dollars every week from depository institutions, causing exacerbation of the problems which existed at that time, including disintermediation.

I believe that was the reason that this action was taken at the time, but the savings and loan business has had problems through the years with brokered funds. On that point, I would suggest that the letter that I received dated January 25, 1984, from the former head of the staff of the U.S. League of Savings Institutions, Mr. Norman Strunk, who served with that organization for some 40 years, be entered in the record.

[The following information was submitted for the record.]

INTERNATIONAL UNION *of*
BUILDING SOCIETIES AND SAVINGS ASSOCIATIONS
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SECRETARY-GENERAL
NORMAN STRUNK
CHICAGO, ILLINOIS U.S.A.

January 25, 1984

Mr. Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 G Street, North West
Washington, D. C. 20552

Dear Ed:

This letter is written to express commendation to the Board for its forthright action on the subject of broker deposits and my unequivocal support to the regulatory proposal on this subject of January 16, amending various sections of the rules and regulations for insurance of accounts.

In this connection, I speak as a private citizen, but one concerned about the soundness of our thrift institutions and with a background of 45 years of experience with, or closely related to, the savings and loan business in the United States. I was chief of staff of the organization, now known as the United States League of Savings Institutions, from 1951 through 1979, having been employed by the League initially in 1938. I think these years have given me a considerable perspective on the business, knowledge of its strengths and weaknesses, the source of its problems in the past, and ways to avoid problems in the future.

In my mind, there is no greater source of problems to the business (and the FSLIC and FDIC) than the development of funds for it by disinterested individuals selling essentially FSLIC and FDIC insurance for a commission and with little or no concern for the current integrity or for the long-term health of the institutions in which deposits are placed.

The program of the money brokers and some in the security business in selling insured deposits had a very detrimental effect on the business in the early to mid-1960s. Those were years before ceilings on interest rates were imposed on the rates thrift institutions could pay. Some institutions offered higher rates than others and accepted vast sums of money from brokers. The result was loss of control of the interest rate decisions that should be made by management and directors in contrast to outsiders. Money was moved from smaller cities to the larger ones, and from markets with responsible savings and loan management to those dominated by promoter types. So much money was placed in some institutions that these institutions almost shoveled the money out to builders rather than lending it with any semblance of prudence.

The result was the first wave of post-depression failures in the savings and loan business, and a considerable burden on the Federal Savings and Loan Insurance Corporation. There was a severe public relations problem for the business and concern on the part of the Government Accounting Office as to the adequacy of the resources of the FSLIC. The Board then acted to prohibit insured associations from paying a commission in the solicitation of deposits (which regulation, unfortunately, was repealed a few years ago). To assure that the resources of the FSLIC would be adequate, Congress in 1965 provided that the Board could supplement the funds of the Corporation by requiring insured institutions to make a special, temporary deposit in it up to 1% of savings.

This 1965 experience and the strain imposed on the resources of both the FSLIC and FDIC in recent years should serve to remind everyone that the resources of these institutions are finite, while their obligations are tremendous and open-ended. FSLIC and FDIC insurance was provided by Congress in the depths of the depression to instill confidence in our banking system. Concern with respect to the adequacy of the resources of the insurance corporations two years ago caused Congress, by special resolution, to state that the full faith and credit of the government would be behind them. This was necessary at that time to assure the public's confidence in these corporations and continued stability of American financial institutions.

By this action, Congress certainly did not intend to write a blank check on irresponsible growth in insured deposits and unlimited liability of the FSLIC and FDIC in relation to their resources. The heads of the agencies must at all times be conscious of the resources of the insuring corporations with respect to the obligations assumed. There must be some way to limit the obligations of the FSLIC and FDIC. In this context, regulations, such as those proposed on brokerage activity, are absolutely essential.

I am certain that when the FSLIC and FDIC were created by the Congress in 1933 and 1934, it was never intended that banks and thrift institutions would willy nilly receive funds from security brokers; money solicited hundreds or thousands of miles from the banking institution's offices. Deposit insurance was designed to restore confidence in our banking system and to protect the accounts of small- or medium-size depositors who, in some instances, had little choice in the banks or thrift institutions they could use and who could not be expected to read and understand the balance sheets of financial institutions. Deposit insurance was never intended to protect the very large depositor and those who, presumably, could make an intelligent choice between one institution and another, such as the customers of security firms could be expected to do.

The activities of the brokerage firms in soliciting deposits for insured institutions that pay the highest rates of interest in this deregulated economy -- which parenthetically means institutions which charge the higher fees, highest rates of interest and make the riskier loans -- may be linked to the activities of the brokerage firms selling the single premium deferred annuities of the Baldwin United companies. Here the result of brokerage firms soliciting "deposits" for a fee is available for all to see. A similar situation must not be allowed to develop with respect to the nation's banking and thrift institutions. Losses would not be picked up by the brokerage concerns, as with the Baldwin United annuities, but by the FSLIC and FDIC -- and possibly by American taxpayers. Already there are examples in recent years of problems in the banking business as a result of virtually an unlimited ability on the part of banks to get deposits from money brokers.

To me, it is absolutely essential for the continued integrity of the FSLIC and FDIC, the health of our thrift institutions, and that of many parts of our banking system that the practice of financial institutions building their deposit base through brokerage funds be stopped. There may be some disagreement as to the best way to get at the problem, but it is essential that the growth of broker deposits be curbed.

Washington Notes quotes Deputy Treasury Secretary R. T. McNamar to the effect that the use of brokered deposits by poorly managed institutions can be handled as an individual supervisory matter. Through years of observing supervisory actions of the Board and the banking agencies, I doubt this very, very much. Use of the cease and desist orders and other actions are carefully circumscribed by law and have not notably been effective in preventing problems that have had to be washed up in recent years by the FDIC and the Board -- problems that came not as a result of a mismatch of deposits and asset maturities, but as a result of irresponsible lending and deposit acquisition practices. Generally, supervisory "clout" is too mild, comes too late and after severe damage has been done.

I happen to believe personally from long experience that the proposal of the Board and the FDIC to impose a maximum of $100,000 coverage per insured bank or insured savings and loan association for total deposits placed by or through a single deposit broker is by far the best, if not the only practical means of bringing this very dangerous practice under control.

Again, I commend the Board for its forthright action, for acting joinly with the FDIC, and express my wholehearted support for this regulatory proposal.

Sincerely,

Norman

Norman Strunk
Secretary-General

NS:ep

Mr. **Gray**. In his letter he said:

> In my mind there is no greater source of problems to the business (and the FSLIC and FDIC) than the development of funds for it by disinterested individuals selling essentially FSLIC and FDIC insurance for a commission and with little or no concern for the current integrity or for the long-term health of the institutions in which deposts are placed.

Now in December of 1982, as a result of actions taken by the Congress for the first time in almost 20 years, depository institutions were provided a competitive instrument, namely the money market deposit account, that was intended at least in part to enable depository institutions to recapture a substantial amount of funds that were being siphoned off by the money market mutual funds.

So during the period that we had the 5-percent cap on brokered deposits, we had regulation Q restraints and also had a relatively stable economy, and we certainly did not have the kind of interest rate swings that we experienced in 1981 and 1982. So a cap at that time coincided, at least in my view, with the regulated liability structure for a thrift institution. Indeed because of the regulation Q restraints, the volume of brokered deposits at FSLIC-insured institutions during those two decades was miniscule relative to the volume in brokered funds which has now been aggregated at these same institutions. The regulated liability structure has now all but disappeared at thrifts. We are now operating in a virtually completely deregulated liability environment, and we are now experiencing the indirect consequences: instantaneous access to unlimited, deregulated deposits which, in too many cases, have been transformed through imprudent investments, almost overnight, into mammoth bad assets written against the beleaguered FSLIC fund.

I'd also like to note, as a historical matter, that during the period of 1960 through 1982, the Board's rules actually contained both a 5-percent limit on the acceptance of brokered funds, and a 2-percent ceiling on commission payments for such brokered transactions. The rules originally were adopted because of concerns that advertising abuses and competitive pressures arising from brokered funds' use could affect the safety of some institutions. The 5-percent limit reflected a particular concern that brokers were siphoning funds from other parts of the country into California, which at the time allowed its S&L's to pay slightly higher rates on passbook accounts.

In 1980, the Board removed the 5-percent limit primarily because the California differential no longer existed, but noted that it would review the changes if abuses occurred. In 1982, the Board removed the ceiling on paying brokerage commissions in view of new DIDC actions on commissions for rate-regulated accounts, and because at that time, there was no evidence of significant adverse effects from increased competition by S&L's for funds in the marketplace. But again, the Board cautioned that it would continue to monitor the use of commissions and would consider further regulatory action if safety and soundness concerns arose.

Again, I have seen nothing in the 1980 act which created the DIDC which suggests to me that the deregulation of liabilities was intended to serve as a subterfuge to enable nondepository institution entities to sell at will Federal deposit insurance.

Certainly the Federal deposit insurance system, as I said before, was never fashioned to be able to underwrite the huge risk which is piled on top of the underwriting of liabilities which are gathered and generated by depository institutions themselves—to underwrite this huge risk which is growing by leaps and bounds, which is produced by the sale of Federal deposit insurance by a proliferating host of money brokerage operations around the country, and which is causing, as a result of the use of the instantaneously accessed funds, tremendous problems for the Federal Savings and Loan Insurance Corporation.

And, in particular, today, I would point to a case in California, San Marino Savings and Loan, which the Bank Board took into conservatorship several weeks ago. That particular institution had brokered funds at the level of 40 percent at year-end 1983. And, as Mr. Isaac stated before, on the very same day that we had an examiner in that institution, at the very same time that there was a cease-and-desist order by the State commissioner, and there was also a request by our supervisory agent that the institution decline to accept new, or rollover, uninsured deposits in fact, they accessed some $40 million in insured brokered funds which obviously just created more and more problems for the institution.

I would like to add one other thing. There seems to be a perception that the savings and loan business is against the essential outlines of the proposed regulation. In fact, the California League of Savings Institutions from your own State, a State where there are probably 65 percent of all the brokered funds in our institutions—and that league, I would point out, represents savings and loans throughout the State—voted overwhelmingly to support the proposed regulation, as did the U. S. League of Savings Institutions a week or so ago.

MISUSE OF BROKERED FUNDS

Now I'm not saying that everybody is particularly totally happy with the proposed regulation. But I am saying that there is a general understanding on the part of more and more people in the savings and loan industry that their own Federal deposit insurance fund and the viability of that fund is in fact threatened by the activity that we are seeing by the misuse of brokered funds.

Let me point out one other thing while I have the microphone here. In October 1983, the Bank Board directed the principal supervisory agents of the 12 Federal Home Loan Banks to impose a 5-percent ceiling on brokered funds for those institutions which we would describe as troubled institutions; that is, those institutions which were in a supervisory category and according to the way we determine this would have roughly less than 3 percent net worth.

So that has been in place since October for troubled institutions. Chairman Isaac imposed the same limit on State-chartered nonmember FDIC-insured institutions subject to an enforcement action or party to a memoradum of understanding. We have taken steps to address that directly.

My real concern is that what we are seeing today is not a problem with troubled institutions. Rather, we are beginning to see what were healthy institutions become failures and very, very quickly, and our supervisory directive obviously does not apply to nonsupervisory cases.

Senator Cranston. How long had San Marino been a troubled institution before it was found that it had brokered deposits? I'd appreciate a rather brief answer.

Mr. Gray. Thank you. I don't have the answer for you, so I will supply that for the record.

Senator Cranston. If you could supply that for the record, I would appreciate it.

[The following information was subsequently submitted for the record:]

Our examiners first documented potential significant problems at San Marino in early 1983. San Marino Savings began acquiring large amounts of brokered savings during the first half of 1982. By December 31, 1982, brokered savings accounted for more than 70 percent of total deposits. The association grew from less than $25 million in assets at December 31, 1981, to nearly $100 million in assets by June 30, 1982, and more than $175 million in assets at December 31, 1982. It was during this period that the association began funding the condominum conversion loans which eventually led to the association's curent problems.

Senator Cranston. The fact is that even with your proposed rule, San Marino can still do what they were doing after this proposed rule goes into effect. Isn't that the case; with brokered deposits?

Mr. Gray. Absolutely not, because they're in conservatorship.

Senator Cranston. Prior to conservatorship, presumably it could have done it, could it not?

Mr. Gray. Well, at that time the level of brokered funds was well up to the 5-percent limit which had been established in October. The increase in volume was apparent over a period of time. It was very clear in that case that the management chose to either ignore or snub its nose at the October policy. From everything I have been able to gather from our supervisory examination people, it snubbed its nose. This is why the State commissioner himself joined with us in the action that we took.

Senator Cranston. I think the question really is whether this rule in fact will stop behavior that you consider unwise. History seems to indicate that those that are intent upon doing such things find a way to do them, and I am concerned about a rule that would affect all the institutions when you're really after just a few.

Mr. Gray. Well, we are really talking about—in terms of the use of brokered funds in any way—only around one-fifth of all FSLIC-insured institutions in this country.

Senator Cranston. I know.

Mr. Gray. We at the Bank Board, assuming action by the Bank Board, do not see this as a panacea. It is merely one tool for us to get at the problem of excessive growth and excessive risks, but we have a number of other things that we are exploring now to try to get at the problem.

So this is one part of an overall means to address that problem, Senator.

Senator Cranston. Frankly, aside from the specific issue of brokered deposits, I'm concerned by news accounts and other reports that raise questions about some of the actions that you've taken and whether you are really in a position to fairly review the record prior to final agency action on the proposed rule.

According to news reports you have spoken frequently on the proposed rules before a variety of trade associations and other organizations. Can you recall now or can you later provide the committee with the exact date and location of those meetings?

Mr. GRAY. Absolutely, I can.

Senator CRANSTON. You can or you cannot?

Mr. GRAY. Yes, I will. But let me just add, if I may, in every case I was talking about the unrestrained use of insured funds. I was not talking about any final action and I made it very clear in every speech that I made that the Board would look very carefully at all the comments, and I, in committee hearings on the House side last week, said that I would personally review every comment letter the FSLIC had received before the Bank Board would take any action on this.

Senator CRANSTON. When you submit that list, would you indicate which of the appearances and speeches were open to the public and press and which occurred behind closed doors?

Mr. GRAY. Sure.

Senator CRANSTON. Could you furnish us with the text or the transcript of your remarks?

Mr. GRAY. Sure. The text, by the way, is all public because I made the same address before the California League and the Texas League which was made publicly at a recent meeting of the U.S. League of Savings Institutions. So that is precisely the text I used. In fact, I used the very same one.

Senator CRANSTON. You used the same precise text?

Mr. GRAY. The same precise text.

[The following material was subsequently supplied for the record:]

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

EDWIN J. GRAY
CHAIRMAN

April 10, 1984

Attached is a copy of the actual orator text from which I delivered speeches to:

1. Board of Directors, California League of Savings Institutions, Sunday, February 26, 1984, 3 P.M., Newport Beach Marriott, Newport Beach, California: at the specific invitation of Chairman Ray Martin and President Dean Cannon.(excluded insert between pages 69 and 70).
2. Full Management Conference, California League of Savings Institutions, Monday, 9 A.M., February 27, 1984, Newport Beach Marriott, Newport Beach, California: at the specific invitation of Chairman Ray Martin and President Dean Cannon (excluded insert between pages 69 and 70).
3. Board of Directors, Texas Savings and Loan League, Thursday, March 1, 1984, 9 P.M. Anatole Hotel, Dallas, Texas, (See attached letter dated March 9, 1984, from Dr. Joseph R. Ewers) (excluded insert between pages 69 and 70).
4. Annual Legislative Conference, U.S. League of Savings Institutions, Capitol Hilton Hotel, Washington, D.C., 10 A.M. Tuesday, March 6, 1984, covered by the press (See March 22, 1984 letter from William D. O'Connell) (included insert between pages 69 and 70).

Edwin J. Gray

ADDRESS ON BROKERED DEPOSITS BY EDWIN J. GRAY, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

I appreciate the opportunity to share with you directly my views and my concerns regarding brokered funds.

I believe third-party, federally guaranteed, and yes federally subsidized, money broker activities are a spreading cancer on the Federal Deposit Insurance System. They represent a direct threat to the present and future safety and soundness of Federal deposit insurance.

For any institution represented here today that is not truly interested in the maintenance of a viable Federal Deposit Insurance System, my remarks may not have much meaning.

However, for those institutions which believe, as I do, that Federal deposit insurance underlies the very credibility of their capacity to do business with the public, I hope they will pay very close attention to the strongly held concerns I have.

At the outset, let me remind you that it is my sworn duty as the operating head of the Federal Savings and Loan Insurance Corporation to protect the safety and soundness of the fund.

In the truest sense, it is your fund. Each year, your institutions contribute sizable amounts of money through premium assessments to support the continued operation of the FSLIC.

The public trust I and my colleagues at the Bank Board must oversee on your behalf, and on behalf of the public, has been delegated to us through statute by the Congress of the United States.

In all honesty, I would be derelict in my solemn duty to head, manage and protect the fund, if I failed to call to your attention the alarming manner in which third-party money brokering activities are today laying the groundwork for the ultimate demise of "savings" institutions as we have known them and for the Federal Deposit Insurance System as we have known it for half a century.

I am frankly shocked by the passivity, indeed misunderstanding as to the high stakes implications for the future of savings institutions, which seems to be the case of many in the industry as we approach the money broker issue.

It is instructive to begin, I believe, by examining the straightforward language contained in the Economic Report of the President which was transmitted to the Congress only a month ago.

That language makes very clear the critically important role played now—today—by the Federal Deposit Insurance System.

The report says: "Two types of governmental institutions (the Federal Deposit Insurance System and the Federal Reserve System) now serve to prevent a financial panic from cascading into a collapse of the banking system." The report goes on to say the FDIC and FSLIC "provide deposit insurance so that the failure of one unhealthy institution will not produce panic runs on healthy institutions."

Fifty years after President Roosevelt enacted the laws creating FSLIC and FDIC insurance, the Reagan administration's own Economic Report echoes the intent of a Congress and a President who served in the darkest days of the Great Depression.

It was President Roosevelt who stated, in his 1934 message to Congress urging creation of the FSLIC, these words.

"These (savings) institutions are custodians of funds for small savers. Insurance of this type is necessary to arrest any further drain on these institutions."

Indeed, earlier in that same year, the then-general counsel of the Federal Home Loan Bank Board, commented:

"The object to be accomplished by the suggested (FSLIC) insurance . . . is primarily to stabilize confidence in home financing institutions."

Indeed, the 1984 Economic Report of the President, states in the clearest possible language, the original, indeed the continuing, purpose of the Federal Deposit Insurance System: ". . . to prevent a financial panic from cascading into a collapse of the banking system . . . (by providing) deposit insurance so that the failure of one unhealthy institution will not produce panic runs on healthy institutions."

Yet, there are those today—those who do know better, or ought to know better—those who persist in pursuing the mistaken notion, because it serves their own purposes, that the purpose of deposit insurance is to insure accounts, and for that matter their accounts. These are people who operate financial organizations which are not, and do not qualify as, depository institutions.

Indeed, those who are today pushing this erroneous notion the hardest are those who seek to legitimize the sale of Federal deposit insurance through their own unregulated financial entities. They are the money brokers.

Money brokerage firms are not depository institutions.

Nevertheless, there can be no mistaking their intentions. Michael Blumstein of the New York Times put it succinctly in a recent article. He said: "Like a tidal wave pressing against a seawall, the securities industry is on the verge of crashing through the banking industry's territory.

"One of the securities industry's main goals is Federal deposit insurance."

Mr. Blumstein went on to say: "Since December 1982, when banks and thrift units began offering federally insured money market deposit accounts, the securities industry has been nothing short of a fanatic in its effort to break through the banking barrier."

Just last week, another article in the New York Times by staff writer Kenneth Noble reported that Merrill Lynch has begun a grass roots lobbying effort "to recruit other brokerages that have retail customers across the country to join the campaign . . . to wage a lobbying campaign against the proposed regulations" put out for comment on January 16 by the Bank Board and the FDIC.

The article says Merrill Lynch has sent out letters to a half million customers and quotes a Merrill Lynch executive as saying his firm has urged Shearson/American Express, Dean Witter, Reynolds and Prudential Bache "to make appeals to their customers" to lobby against the proposed rule.

Again, as Mr. Blumstein pointed out so clearly in his earlier article: "One of the securities industry's main goals is Federal deposit insurance."

Ladies and gentlemen, Federal deposit insurance was the birthright of banks and savings institutions. It was never meant by the Congress to subsidize the operations of the securities industry through its money brokering subsidiaries, or the operations of other money broker firms.

In my view, the sale of Federal Deposit Insurance by these totally unregulated money brokering entities perverts—yes, grossly distorts—the purpose Congress meant the FDIC and FSLIC to serve, from the beginning.

Congress provided Federal deposit insurance to bolster public confidence in the stability and safety of depository institutions themselves to—as the economic report of the President reaffirmed last month—"prevent a financial panic from cascading into a collapse of the banking system."

The sale of Federal deposit insurance by nondepository institutions—whether it is by the unregulated money brokering subsidiaries of Wall Street securities firms, or other such entities which likewise seem determined to cash in on the unintended Federal subsidy it provides them—goes well beyond the scope of purpose Congress, itself, intended.

I must emphasize again, the reason Congress created the FSLIC and FDIC was, and continues to be, to bolster public confidence in the stability of the Nation's depository institutions so that—as was stated so well by the economic report of the President last month—"the failure of one unhealthy institution will not produce panic runs on healthy institutions."

The purpose was not to insure accounts. That was the scheme Congress chose to accomplish its objective of instilling and maintaining public confidence in the stability of the Nation's depository institutions—banks and savings institutions.

One of the money brokers quoted in last week's New York Times article I've already referred to calls this "A Consumer Issue." Another broker is quoted as saying: "We are financial intermediaries brought on by financial deregulation."

Now that may well be what he believes, but, in my view, it misses the point and begs the question regarding deregulation. Deregulation of what liabilities? In no way did the Congress, itself, intend that the deregulation of liabilities at depository institutions would serve as a subterfuge for extending the sale of Federal deposit insurance beyond the confines of depository institutions themselves—to the securities industry and other nondepository institution entities we know as money brokers.

In that sense, this is not a legitimate "consumer" issue at all. In fact, that reasoning twists beyond recognition the fundamental purpose Federal deposit insurance has always been intended to serve by the Congress, itself.

Congress has never, implicitly or explicitly, assigned the marketing of Federal deposit insurance to nondepository institution entities. On the other hand, the Congress has, and has always had, the prerogative to do so. But it has never chosen to do so.

Your institutions, and the Nation's commercial banks, are the only financial intermediaries which have ever been assigned the sale of FSLIC and FDIC insurance of accounts by the Congress.

And why? Because depository institutions pay a very special role in our society. It is a role which has been specifically defined by the Congress. Your institutions are congressionally defined and mandated instrumentalities of public policy. Your institutions are required by law to serve the depositor and investment needs of communities in which your institutions do business. That community service role is literally bathed in statutory fiat and regulatory authority delegated by the Congress to governmental institutions such as the Bank Board, the FSLIC and FDIC.

This is why your savings institutions are called upon to pay the high cost of regulation.

Indeed, it is why the money brokers, which are not statutorily defined or congressionally-mandated private sector instrumentalities of public policy, are neither regulated in any way, nor must they pay any of the costs which must be borne by the regulated depository institution.

To be chartered as a savings institution or bank, and to qualify as a federally insured institution, you must pay a heavy regulatory burden—including the costs of compliance, supervision, examination, extensive record-keeping, reporting requirements, reserve requirements, deposit insurance premiums, and a long list of other relatively onerous regulatory mandates.

Cost estimates of compliance with Bank Board reporting requirements suggest that FSLIC-insured institutions spend 1.8 million hours per year in this endeavor alone.

Had depository institutions been paid at market rate for funds held in reserve by the Federal Reserve last year, they would have earned an additional $4.1 billion. In addition, the estimated costs of operating the Federal Home Loan Bank System, the Federal Reserve System, the FDIC and the National Credit Union Administration—costs borne fully by depository institutions—totaled more than $1.3 billion last year.

Money brokers—in spite of their self-serving proclamations that they, too, serve some never specifically-defined public policy purpose—pay none of the regulatory, or even deposit insurance cost burdens, your institutions must bear.

It is no wonder, then, that their nonregulated operations benefit substantially. And in this manner they, in fact, benefit from a very substantial, unintended, Government subsidy. And, it is no wonder they are so ardently seeking to legitimize their ability to ride high and free of charge atop the Federal Deposit Insurance System through the sale of deposit insurance. With none of the costly regulatory overhead of banks and savings institutions, they are earning a very handsome profit on the Government subsidy. They pay not a penny in FSLIC or FDIC insurance premiums.

Apart from the threat their activities pose to the present and future viability of the deposit insurance system itself, which I will get into more deeply later in my remarks, the consequences of permitting this unintended and inequitably applied Government subsidy to continue to be exploited by the money brokers will sooner or later place your institutions at such a deposit marketing disadvantage that it will only be a matter of time before the money brokers—and not your institutions—will be marketing the lion's share of FSLIC and FDIC-insured deposits in this country.

Let me cite a glaring, self-serving example here of how one of the very largest Wall Street securities firms, whose money brokering subsidiary deals in billions of dollars in brokered funds, would solve the problems we who direct the deposit insurance system are seeing. This firm would limit the sale of deposit insurance by money brokers to individual accounts. No more so-called institutional funds could be insured under its proposal. Just individual accounts.

And, who might those individuals be? The same individuals who live in the communities your institutions are meant to serve—the retail customer. For Federal deposit insurance purposes, that customer is, and ought to be, your customer. Did the Congress ever intend that the Wall Street firm's money brokerage operation should sell your deposit insurance to that customer? I don't think so. And, if you let this continue, sooner or later—and probably sooner than you think—you run the very real risk of relinquishing that individual customer to the money broker.

The fact is, the Wall Street firms, through their money brokerage operations, are carrying on massive advertising campaigns across the length and breadth of the land which say: Come to us and we'll insure your account with FDIC and FSLIC insurance.

The handwriting is on the wall. If you let him sell the deposit insurance, he will take the customer away from you. The special, yes unintended Government subsidy he gets for selling Federal deposit insurance, will assure that this occurs in the future.

For your "savings" institutions, this can only end in transforming your operations into one-sided, non-deposit gathering, lending and mortgage banking entities. This has never been the role of the depository institution in America. But, it will be, by-and-by—and all too soon—if you as savings institution executives fail to come to grips with the stakes involved here, down the road.

Is this what you really want? Have you thought about it clearly? Have you thought about it in terms of just how it will impact on the future of your institution, and the savings institutions industry?

If you want the money brokers to become the Nation's deposit gatherers—which they surely will become, absent firm, decisive and expeditious remedial action—then it is clear to me that you will end up not being "depository" institutions at all.

Let no one in this room harbor the slightest doubt that the money brokers are in a position, for the reasons I've outlined, to take over, and take away from you, the federally insured deposit gathering function your institutions have had for so many years. The money brokers have the financial resources to do it. And, they intend to do it.

Under these circumstance, just how long can you as an industry expect to depend on the continued sympathy of the Congress—a sympathy you now have, and have had for a long time—in your role as—"savings"—institutions?

Just how long do you think you will have the conferred benefits provided by section 593 of the Internal Revenue Code? Just how long do you think you'll be able to enjoy the benefits now provided to your institutions by membership in the Federal Home Loan Bank System?

"Savings" institutions, as "depository" institutions, enjoy these conferred benefits now. When your institution ends up as simply a mortgage banking operation because some other kind of entity gathers your deposits for you, I wonder how long you'll be able to rely on the sympathy of the Congress to continue to extend such benefits.

These benefits are intended for "savings" institutions—not mortgage bankers.

It is time every one of you look beyond the end of the month, beyond the next financial statement, beyond the next six months, beyond the next year—to the shape of your future as—"depository"—institutions under the scenario I have outlined.

Remember, the new wave of money brokering—already growing like wildfire—is still only in its infancy.

Feeding this infant lion may seem simple and innocent today. As he grows, he becomes more dangerous. Chances are very good he will consume you for dinner before very long.

It is time you wake up to the stakes this issue poses for your future.

If you don't, if you fail to push aside the trees so you can see the forest beyond, then I fear deeply for the future of the industry. If you are intent on sacrificing the long-term view for short-term expendiency, you will have only yourselves to blame. In the end.

What the skyrocketing growth in third-party, federally guaranteed and federally subsidized activities of the money brokering industry will mean to your Federal deposit insurance system—if this activity is not reined in very substantially, and very soon—is of the deepest concern to me.

This activity is literally out of control. It is growing by leaps and bounds. If the present rate of brokered funds were to continue out into the future, it would account for fully one third of all deposits in FSLIC-insured institutions by the end of 1985.

What would it be in 1987? In 1990? None of us knows.

But, when you consider that this new wave of third-party, federally insured money brokering is still only in its infancy; when you consider that money brokerage is proliferating very rapidly; when you take into account what New York Times reporter Blumstein called the "fanatic" manner in which the securities industry is pursuing Federal deposit insurance, then you must also realize that the money brokers have only just begun. Frankly, I can see no reason whatsoever why this activity won't continue to mushroom out of sight—unless firm, decisive action is taken soon to bring the FDIC and FSLIC-insured activities of the brokers under control.

What does this mean for the Federal deposit insurance system? It means that in addition to underwriting the risk of the deposits your institutions gather through your own marketing activities, a new magnitude of risk is being layered on top. This new additional and unintended risk is represented by the sale of deposit insurance by the money brokers.

Is it reasonable to expect that two Federal deposit insurance agencies—the FDIC and FSLIC, whose aggregate reserves total slightly more than $20 billion—can possibly be expected to underwrite the total risk of trillions of dollars in deposits your institutions market, plus the skyrocketing risk of the rapidly rising volume of billions and billions of dollars in new third-party federally insured brokered deposits?

The fact is, the Federal deposit insurance system was never ever meant to underwrite this huge new risk, this double whammy, on the FSLIC and FDIC.

The FSLIC and FDIC were never fashioned through the premium structure to bear such a skyrocketing risk burden. And I would remind you that the money broker never pays a penny in insurance premiums. That cost is borne by your institutions alone.

Remember, the total reserves of the FSLIC and FDIC represent but a tiny, almost infinitesimal fraction of the total growth in federally insured brokered deposits, which we have every reason to envision ahead.

You must recognize that a substantial part of the little more than $6 billion in reserves held by the FSLIC will be required to pay for liquidations and costly assisted mergers we can foresee, or can expect, in 1984 alone, most of them as a direct consequence of brokered money.

The ratio of FSLIC reserves-to-deposits has deteriorated steadily in recent years to its present point of virtually 1 percent given the lightning fast growth of deposits, and the nature of the problems the FSLIC is already facing as a result of brokered funds activities, there is no reason at all to expect any strengthening of this reserves-to-deposits ratio in the foreseeable future—unless the problem is addressed head on, and soon.

The last time this reserves-to-deposits ratio dipped under 1 percent—which we're now very, very close to—was in the early 1960's. This prompted the Congress, itself, to establish a costly secondary reserve additional assessment premium on savings institutions.

The skyrocketing third-party brokered funds activity we're now seeing leads us to the inescapable conclusion that the current historically low ratio will continue to drop.

This, in turn, will surely prompt imposition of additional premium assessments on FSLIC-insured institutions, just to bring the ratio back to what it is today, which is, as I say, already well below historic levels.

Frankly, this will be very costly to FSLIC-insured savings institutions, involving billions of dollars in additional assessments in the future.

Just this morning, I received a report from my staff which shows that if insurance premiums were increased by one-eighth of 1 percent of total deposits—based on the January 1984 deposit base of $625 billion for the industry—the additional cost to the industry would be $781.1 million.

This $781 million in additional premium expense would amount to almost half of what the industry is expected to show in earnings in 1983, $1.7 billion.

I don't need to tell any of you that the reported earnings we expect in 1983 were very substantially undergirded by certain accounting procedures.

Attached report:

FEDERAL HOME LOAN BANK BOARD
Washington, D.C., March 5, 1984.

To: Chairman Gray
From: Steve Goldstein
Subject: Talking Points on Insurance Premiums

1. If insurance premiums were increased by one-eighth of 1 percent of total deposits:

Based on the January, 1984 deposits base of $625.4 billion, the additional cost of the industry would be $781.8 million.

This $781 million additional premium expense represents almost half the industry's $1.7 billion earnings in 1983.

An average institution would pay an additional $258,000 in insurance premiums.

2. If an assessment of 1 percent of deposits were levied:

The industry would have to invest $6.254 billion based on January, 1984 deposits of $625.4 billion.

Since the FSLIC pays only about 9 percent on reserves and associations can earn an average of 11.6 percent on investments, the earnings loss from the assessment would be approximate $163.0 million.

This $163.0 million earnings loss represents almost 10 percent of the industry's 1983 $1.7 billion earnings.

An average association would have to invest $2.064 million in the FSLIC.

The $2.064 million investment would cost the association $53,800 in lost revenue.

These higher premium assessments would have to apply across the board to every FSLIC-insured institution. Whether or not that institution chooses to take in third-party brokered deposits.

Indeed that slow grower is going to have to pay the price of higher insurance premium assessments because some institutions are so determined to grow so fast with their heavy ingestion of brokered money.

We cannot operate a deposit insurance fund without sufficient reserves, any more than you can operate your institutions with insufficient capital.

Again, the lightning fast growth of third-party federally guaranteed brokered funds activity we are witnessing can only exacerbate the problems of the FSLIC. And, indeed, it is doing just that.

The money broker has no incentive to practice any sort of due diligence, whatsoever.

He sucks money out of local communities, packages it up into bundles of $100,000 or less so it will qualify for Federal deposit insurance, and makes it instantaneously available to any institution prepared to pay the highest price for the funds.

A telephone call and a quick wire transfer is all that's needed. No need for the money broker to worry. After all the funds are insured. Unfortunately, we're seeing a growing crescendo of cases in which what was, only some months ago a healthy institution, has become a failing institution. The ease of access to brokered money not only has brought about incredibly fast deposit growth to such institutions but this growth, just as quickly, has transformed itself into risky investments which, in turn, have produced bad assets.

In fact, the nature of our toughest cases has now changed to investments in bad assets. That's a real change from what we were seeing at the FSLIC during the dark days of 1981 and 1982 when brokered funds weren't the issue. At that time, earnings spread problems characterized the preponderance of cases the FSLIC had to deal with. Those problems were expensive, they were difficult, but they were solvable. Asset quality was, by comparison, very good compared to the nature of the problems we are encountering today.

It is not unusual today for a money broker to place funds at an institution or bank and, at the moment of the transaction, to suggest how the funds can be invested very quickly. A particular broker may already have lined up the project to be funded.

The result of all this: Quick, easy money, hurry-up investments, bad loans and bad assets. Because of the speed with which these kinds of transactions take place, and because we're talking about the transformation of what were healthy institutions into very expensive failures—particularly because of the new bad assets problems—we are encountering very costly difficulties. These very expensive failures are eating into the FSLIC's reserves, and in this way, further exacerbating that reserves-to-deposits ratio I talked about earlier.

These brokered funds-related problems are occurring so fast that by the time our examiners discover such problems, it is simply too late. The FSLIC is left holding the bag.

In truth, you don't need too many of these kinds of problems to end up on the FSLIC's doorstep, to very seriously endanger the insurance fund.

Indeed, from my everyday exposure to the new problems coming on line, I have reason to say that money broker activities already have begun to jeopardize the Federal deposit insurance system. With what we're now seeing, added to the enormous new risk these brokered funds activities are piling onto the deposit insurance system, it is not only conceivable, but in my view very possible, that at some point in the future, massive infusions from the U.S. Treasury—and hence American taxpayers—may well be necessary to shore up the system.

I shudder to think of that possible eventuality and the effect on your credibility as institutions to transact business with the public. The point is, we are looking at an emerging very serious problem already for the funds, not to mention the nature of the additional risk we face if such brokered funds activities are not reined in very substantially in some manner very soon.

Because of the multi-dimensional nature of the problems we are seeing already, and for the future, the Bank Board and the FDIC sought to deal with the overall predicament in mid-January.

Whether you like the proposed rule on brokered funds or not, the fact is the legal staffs of both the Bank Board and the FDIC have told us over and over it was and is the only alternative available, based on the insurance statutes, themselves. No other alternative has yet been offered, to my knowledge, which would get at the heart of the problem, based on the insurance statutes, themselves.

The reason the proposal was based on the insurance statutes was to assure that, if the rule were adopted, it would apply in the same manner to all FSLIC and FDIC-insured institutions. That is to say, all banks and savings institutions would be treated alike for third-party brokered funds purposes, in terms of Federal insurance.

This needs to be understood in the light of our desire to make sure that banks and savings institutions would be treated equally.

I know there are those who say they would rather that a proposed rule had been issued which would not have gone so far. However, parity of treatment for all banks and savings institutions for insured brokered funds purposes would simply not have been possible under any proposal which was not based on the insurance statutes themselves, according to the legal staffs of both agencies.

Given the compartmentalized nature of banking supervision, and given the divergence of views on brokered funds by banking regulators, the proposal was the only one available to guarantee parity of treatment by all FSLIC- and FDIC-insured savings institutions and banks.

Clearly, the comment period, which ends March 8, is intended to provide the opportunity for a variety of views to be expressed. We will carefully examine and weigh the comments we receive before reaching any final decision.

However, irrespective of the final outcome, the fact remains that the stakes for the industry and the Federal deposit insurance system are very great. Unless the vastness, yes the enormity of new risk federally insured brokered funds activities pose for the safety and soundness of the Federal deposit insurance system are dealt with decisively and soon, I fear for the future of the Nation's "depository" institutions.

As the operating head of the FSLIC, I simply cannot ignore the clear and very real danger signals ahead. As I have said, the stakes are very great for a deposit insurance system which was never intended to shoulder the massive new and additional risk-burden we are beginning to confront—from a money brokering industry which—like that cuddly infant lion—is growing so fast he may consume the system and your institution all too soon.

TS&L
TEXAS SAVINGS AND LOAN LEAGUE

FEDERAL SAVINGS AND LOAN
1984 MAR 16 PM 2:15
INSURANCE CORPORATION
INSURANCE DIVISION

March 9, 1984

Chairman Edwin Gray
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20522

Dear Chairman Gray:

Durward Curlee requested that I convey to you, Board member Mary Grigsby and your staff the sincere appreciation of the Texas League's Board of Directors and its staff for coming to Dallas to discuss the brokered fund regulation. It was a stimulating and positive learning experience for all of us for which we are genuinely grateful.

I'm enclosing, at Mr. Curlee's request, a draft paper on the Federal Home Loan Bank System's capital situation which incorporates an idea I and others here have been examining for some time. It is not intended necessarily to address the brokered funds issue, but it is nonetheless germane insofar as the financial strength of the FSLIC is concerned. The draft does not represent a policy or position of the Texas Savings and Loan League at this time though the paper will be distributed to our Board of Directors early next week.

We certainly share your concerns and those of the many others about the near term as well as the long term viability of the Insurance Fund. As you have so elequently stated, it is indeed the backbone of our industry. What the Paper attempts to highlight is the proposition that the System as a whole possesses more capital than would be surmized when viewing its individual components. The notion incorporated is that given current and prospective circumstances, perhaps a redistribution of capital among the System's segments would be in order which would have the effect of substantially strengthening the FSLIC without in any way disrupting the financial and related services offered by the 12 District Banks.

You may recall, a somewhat comparable approach was invoked when the FSLIC Secondary Reserve was established while simultaneously adjusting the members stock purchases as an offset. If this proposal is deemed to have merit, such a transfer

408 WEST 14TH STREET/AUSTIN, TEXAS 7870

of capital to FSLIC might be treated similarly and provision made to pay dividends not unlike those paid on the Secondary Reserve. Such a move would serve to highlight the capital strength of the System in positive manner, a much different focus than viewing the FSLIC or the industry in isolation.

Again, our many thanks for coming to Dallas to discuss these critically important issues.

Sincerely yours,

Joseph R. Ewers

Dr. Joseph R. Ewers
Consultant, Texas
Savings and Loan League

JRE:mds

cc: Board Member Donald Hovde
Board Member Mary Grigsby

Enclosure

UNITED STATES LEAGUE of SAVINGS INSTITUTIONS 111 EAST WACKER DR./CHICAGO, ILLINOIS 60601 / TEL. (312) 644-3100

WILLIAM B. O'CONNELL
President

March 22, 1984

The Honorable Alan Cranston
United States Senate
112 Hart Building
2nd and C. Streets, N.E.
Washington, D.C. 20510

Dear Senator Cranston:

I was surprised and disappointed to see the article in the Wall Street Journal today in which you criticized Chairman Gray's remarks before the U.S. League Legislative Conference early this month.

I think your criticism is unwarranted.

So that the record is clear, I specifically invited Chairman Gray to appear at our Legislative Conference to discuss the brokered funds proposal in the context of its impact on the Federal Savings and Loan Insurance Corporation. In his remarks the Chairman made it clear that the bulk of the troubled institutions now on the Board's problem case list involve the use of insured brokered deposits and that he and the other members of the Board were concerned about the impact of these troubled institutions on the FSLIC. He also suggested that if the number of problem cases continued to increase, the FSLIC might well require some additional strengthening, and one possibility would be an increase in insurance premiums paid by our institutions to the FSLIC.

I don't recall anyone of the 500 persons at the conference telling me that he felt "threatened" by the Chairman's remarks. On the other hand, it was clear Chairman Gray's remarks sought to underline and emphasize the connection between the rising number of problem case institutions and the use of brokered deposits by a number of these problem cases.

I should also note that the 52 members of our official policy-making Board of Directors representing every state, Puerto Rico and the District of Columbia unanimously ratified the position taken by our full Legislative Committee of 500 delegates following full debate in both forums. I enclose the text of the resolution adopted as League policy on insured brokered deposits.

THE AMERICAN HOME: THE SAFEGUARD OF AMERICAN LIBERTIES

In the past thirty years I have had the opportunity to observe and work with the Chairmen of the Federal Home Loan Bank Board and, without exception, these men have been persons of great integrity and propriety. Those two qualities are certainly possessed, in my judgment, in full measure by the current Chairman. I regard him as a most dedicated and most capable Board Chairman.

Sincerely,

William BO'Connell

William B. O'Connell

WBO:va

Enclosure

cc: The Honorable Jake Garn
The Honorable John G. Tower
The Honorable John Heinz
The Honorable William L. Armstrong
The Honorable Alfonse M. D'Amato
The Honorable Slade Gorton
The Honorable Mack Mattingly
The Honorable Chic Hecht
The Honorable Paul S. Trible, Jr.
The Honorable Gordon Humphrey
The Honorable William Proxmire
The Honorable Donald W. Riegle, Jr.
The Honorable Paul S. Sarbanes
The Honorable Christopher J. Dodd
The Honorable Alan J. Dixon
The Honorable James R. Sasser
The Honorable Frank R. Lautenberg

Brokered Deposits Position

Resolved, that the matter of insurance of brokered deposits is not a legislative matter, but rather a regulatory matter to be resolved by the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board (for the FSLIC). The U.S. League is in general support of the concern and call to action by the FHLBB Chairman, provided there is provision for a reasonable and appropriate phase-out of existing brokered funds.

Resolved further, the U.S. League officers and staff are instructed to form a working task group to consult with regulatory officials in an effort to develop a reasonable and appropriate phase-out program.

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

April 10, 1984

The attached speech text (before the National Council of Savings Institutions Lawyers' Seminar, on Janaury 31, 1984) also was delivered at a dinner meeting of the Restructuring Committee of the U.S. League of Savings Institutions on February 1, 1984, at the Mission Bay Hilton Hotel, at the Invitation of William B. O'Connell, President, U.S. League of Savings Institutions.

Edwin J. Gray

Federal
Home Loan
Bank
Board

NEWS

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1700 G Street, N.W., Washington, D.C. 20552 Telephone (202) 377 6923

ADDRESS ON

BROKERED DEPOSITS

BY

EDWIN J. GRAY, CHAIRMAN

FEDERAL HOME LOAN BANK BOARD

BEFORE THE

NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

LAWYERS SEMINAR

WASHINGTON, D.C.

JANUARY 31, 1984

Thank you very much:

I am indeed very pleased to have the opportunity to address this distinguished gathering today on a matter I consider to be of critical significance -- both to savings institutions and banks across the length and breadth of the land, but even more important to the American public.

As Chief Executive Officer of the Federal Home Loan Bank System, as Chief Administrative Officer of the Federal Home Loan Bank Board, and as Chairman of the Governing Board of the Federal Savings and Loan Insurance Corporation, I freely admit to caring very deeply about the future of our savings institutions and banks, which as depository institutions, constitute the great bulwark of America's financial system.

I came to Washington from Main Street, U.S.A. I came here to protect the safety and soundness of the Federal Savings and Loan Insurance Corporation which, like the FDIC, serves as the very cornerstone of public confidence in the depository institutions we regulate.

Today, I want to share with you my grave concerns about the threat posed by the rapidly proliferating third-party money brokerage industry to the future of depository institutions as we have known them for the past half century.

Today, I want to share with you my very real fears regarding the manner in which this mushrooming, unrestrained -- and in my view, improper -- activity may already have begun to jeopardize the future viability of the federal deposit insurance system.

Today, I want to talk with you about what I view to be the severe implications of an activity which, if not reined in soon and in very substantial measure, will sow the seeds of the ultimate demise of our community-based, community service-oriented savings institutions and banks -- by gradually eroding their role as local deposit gatherers, and turn them into simply money lending entities.

Let me say that however much I personally want to see our depository institutions succeed and prosper in order to better serve the needs of Main Street America, this issue, in a very real sense transcends those considerations.

This is fundamentally a public policy issue in the truest and broadest sense, because its implications for the future are so very great.

On January 16, in a historic action by the Federal Home Loan Bank Board and the Federal Deposit Insurance Corporation, the issue I want to lay out before you today was addressed in a proposed rule which subjects the matter to full public scrutiny and debate.

I have thought long and hard about the issue. I have approached it from every possible vantage point. In my view, it may well be the most important issue I will deal with during my tenure. It is for this reason that early on in December, I met with Chairman Issac to explore the matter more deeply.

I have come to the conclusion, personally, that the proposed rule is the best alternative available. Indeed, because banking supervision is compartmentalized into a number of jurisdictions, and because such differing views are held on the subject that a common approach acceptable to all parties seemed unlikely, we sought with the FDIC a solution derived from the deposit insurance statutes themselves.

I have come to believe that the extensive staff work which was done at both the FDIC and Bank Board over a number of weeks resulted in a proposal which gets to the heart of the issue.

The proposed rule derives from the conviction of the two agencies -- both of which are entrusted by the Congress to protect the safety and soundness of the federal deposit insurance system -- that third-party money brokerage activities which are predicated on what is, in effect, an open-ended government guarantee represent an outright misuse of what the Congress intended when it established federal deposit insurance a half century ago. It was intended for depository institutions alone and, in that regard, for the small saver. Indeed, one of the unintended consequences of raising the deposit insurance limit to $100,000 four years ago is the abuse of the system we are seeing today.

The proposed rule defines the money broker entity as the principal in any transaction and, therefore, limits federal deposit insurance to $100,000 for that principal placing funds in an individual depository institution.

The proposal, were it to be adopted, would halt the skyrocketing growth in third-party money brokerage and essentially return to depository institutions themselves the fundamental responsibility for gathering deposits underwritten for risk by the FSLIC and FDIC.

Let me hasten to say that third party money brokerage activities -- as such -- would not be affected, except to the extent they rely on what amounts to an open-ended federal guarantee.I believe it is eminently fair to say -- and there is nothing I have been able to find in the literature of the Congress of the United States which even suggests otherwise -- that the overriding purpose of federal deposit insurance, from its inception a half century ago, was to bolster public confidence in the stability of the nation's depository institutions.

Let me repeat: the fundamental, principal and overriding purpose of federal deposit insurance was to bolster, maintain, instill and reinstill public confidence in the stability of America's depository institutions.

The purpose was not to insure deposits. Insurance of accounts was the mechanism, the scheme which the Congress chose in order to accomplish its purpose.

In my view, this is a very critical point because there are those -- particularly in the third-party money brokerage industry -- who would have you believe that the purpose of federal deposit insurance was to insure accounts. They choose to make that erroneous argument frequently because it serves their own purposes. For if it could be successfully argued that insurance of accounts was the main reason, in and of itself, for Congress' decision, then it might logically be argued that such insurance ought not to be the sole province of depository institutions.

Federal deposit insurance in this country evolved principally as a Congressional response to a series of crises dating back to 1864, 1907, and ultimately to the great depression of the 1930s. The early years of that depression proved that other mechanisms which had been used to maintain stability and prevent loss of depository confidence were not working.

The financial panic of the early 30s made this clear. Massive runs on banks, indeed the virtual collapse of the banking system, prompted President Roosevelt to proclaim a bank holiday during which all financial institutions suspended operations.

The emergency produced the Banking Act of 1933. This Legislation began the process of restoring public confidence in depository institutions by, first, requiring all federal chartered banks to become members of the newly-created FDIC. Subsequently, the Congress passed the National Housing Act of 1934 which established the FSLIC.

President Roosevelt summed up his May 14, 1934, message to the Congress urging passage of the legislation which established the FSLIC in these words:

"These (savings) institutions are custodians of funds for small savers, and it is essential that they should be given every protection. Insurance of this type is necessary in order to arrest any further drain on these institutions and to put them in a position to resume their normal operations."

These concerns were echoed by members of Congress and the then-General Counsel of the Federal Home Loan Bank Board, Horace Russell. In January, 1934, he stated:

"The object to be accomplished by the suggested insurance of savings and loan shares is primarily to stablize confidence in home financing institutions and thereby attract savings in this direction..."

The fact is that fifty years ago, the Congress specifically assigned to our savings institutions and banks the custodianship of federal deposit insurance. Such insurance has never, ever -- either implicitly or explicitly -- been assigned to any other kind of financial organization by the Congress.

Through the decades which have come and gone since then, depository institutions have accepted their responsibilities as regulated institutions (and I will cover that more fully later in my remarks) to serve the deposit and lending needs of working men and women, families, the elderly and the young in their communities -- backed by the federal deposit insurance system which, again, has served to maintain public confidence in the safety and stability of our depository institutions.

Indeed, less than two years ago, when interest rates reached historic highs and when a chorus of fears echoed through the halls of Congress that there might be panic-generated depositor runs on troubled thrift institutions and banks, the Congress, in overwhelming concurrence, declared by resolution that the "full faith and credit" of the United States would stand behind the federal deposit insurance funds.

While the nature of the action was different, the purpose was the same as that of a Congress a half century earlier -- to reinforce once again public confidence in the stability of our depository institutions as safe havens for deposits.

It is most noteworthy in this connection that when the Garn-St Germain Act was enacted into law -- and provided to depository institutions a competitive money market deposit account so they could compete with the money market mutual funds -- the money market mutual funds cried out that banks and savings institutions had a distinct, even "unfair" advantage -- federal deposit insurance.

But those cries did not prompt Congress to act to assign federal deposit insurance to the unregulated money market mutual funds. In my view the Congress was wise in not doing so, because the money market mutual funds are neither depository institutions nor are they called upon to bear the heavy burden of regulation depository institutions must shoulder.

For that matter, third-party money brokerage firms are similarly non-regulated and in this regard they are very much like the money market mutual funds.

Nevertheless, the money brokers, which were never, ever assigned federal deposit insurance by the Congress, continue to claim that they somehow ought to be able to sell this government guarantee. Without it, they claim they may go out of business. I find it strange that some who so ardently proclaim their devotion to free market principles, some who traditionally have linked their enterprises to principles of risk and return on investment, have so quickly confused these high principles with a government guarantee.

Indeed, they claim that they are rendering a service to the public by facilitating the transfer of funds from one community to another, and that this achieves a high public policy purpose. I don't intend here to render a judgment on whether the movement of funds in this manner is necessarily good or bad in the abstract. It may or may not be beneficial in a public policy context, depending on where you are. The small community in Idaho, or Kansas or Arkansas might well find that the siphoning off of funds by the money brokers -- funds which otherwise might be used to invest in homes, in local businesses and other community based projects -- does not serve their communities. What if those local funds end up in one of the nation's money center cities? The so-called free-market funds movement facilitation claimed as a virtue by the money broker might, in fact, conceivably end up working to the disadvantage of the small community in meeting its own investment needs.

In all honesty, I am extremely skeptical of claims made to me personally by money brokers that they are driven to achieve a high public policy purpose. In my view, the sole motivation which drives the third-party money broker is the substantial fee collected in such transactions.

I want to make it clear that as a champion of the free enterprise system myself I am not against anybody making a fair profit. The money broker earns anywhere from one-half to as much as two and three percent for his transactions, which are quite simple: Just find the depository institution, healthy or not, make the telephone call, wire the funds, and all that's left is the record-keeping.

Let me emphasize here that I do not hold anything against the money brokers' desire to make a profit and earn a living. He is just doing his job, and doing it well. Rather, it is the system which today permits federally guaranteed, third-party money brokering that I take issue with. I do not believe the Congress ever intended what has developed and the consequences thereof.

The real problem is that not only were money brokers never assigned the responsibility, or granted the authority by the Congress, itself, to market federal deposit insurance, but their activities -- which are, in effect, subsidized by and founded on an open-ended federal guarantee -- already are creating very substantial problems for the federal deposit insurance funds.

Until the advent of the new wave of money brokers, which coincided with the authority granted by the Congress to depository institutions to offer the money market deposit account, the sort of problem cases the FSLIC had dealt with derived from earnings spread difficulties. These were not easy, but they were solvable.

Gradually, as third-party money brokerage has proliferated in giant volume leaps, the nature of many of our toughest cases has now changed to investments in bad assets. We are increasingly finding that this is occurring because very large sums of money come into an institution from the money broker and they are invested rapidly in what turns out to be -- in all too many cases -- very risky investments. It is not unusual for a money broker to place funds in a savings institution or bank and, at the moment of the transaction, to suggest how the funds can be invested very quickly. A particular money broker may already have lined up the project to be funded.

The only way the federal regulatory agencies could possibly keep up with that, and a wide range of other transactions, would be to place an examiner or supervisory official at every institution to oversee and monitor the rapidity of transactions based on the easiest conceivable access to money. That is not my idea of what our role ought to be as regulators. Even if it were, the resources necessary would be infinitely greater than anything available or that I could conceive of.

It must be understood that the money broker has no incentive, whatsoever, to practice any sort of due diligence. The broker's role is to collect the funds, put them in neat packages of $100,000 or less -- never divulging to the depository institution the identities of the account holders -- take the commission, and relegate the funds to that bank or savings institution which is willing to pay the highest price for the funds.

All too often now, and in a growing crescendo of cases where a range of big transactions are occurring, the regulator discovers the consequences of such actions within a matter of months -- but by then it's too late. By then, the pieces which are left from the failure of the institution are dropped on the doorstep of the FSLIC or FDIC.

What may have been a healthy bank or savings institution some months ago has all too quickly become a very costly problem for the deposit insurance funds to mop up.

Were it not inappropriate for me to do so, I could cite a litany of horror stories which have been turned over to the FSLIC in recent weeks. All of them are substantially attributable to the use of easy money received from money brokers.

Worst of all, the FSLIC problem list keeps growing.

The easy access to money broker-supplied funds through the instantaneous transaction, and the growing magnitude of consequences which are ensuing for the federal deposit insurance agencies, simply do not justify the claims which are made in the name of such money brokering as serving an important public policy objective -- at least if one assumes as I do that there is supreme virtue in protecting the safety and soundness of the federal deposit insurance system, and if one assumes as I do that public confidence in our depository institutions depends on the continuing credibility of the deposit insurance funds.

This is like a spreading cancer on the federal deposit system.

In less than a year and a half, the growth in third-party brokered deposits at FSLIC-insured savings institutions has mushroomed so fast that -- if the rate of growth were to continue -- one third of the deposits at these institutions would be in brokered funds within three years. Instead of today's $34-plus billion in brokered funds at FSLIC-insured institutions, that growth rate would mean a total of more than $260 billion in such deposits by the end of 1985. That is a nine-fold increase, all of which would be totally underwritten for risk by the FSLIC. What would such exponential growth produce in brokered deposit volumes at FSLIC-insured institutions in five years? Seven years? Ten years?

There are those who argue that the free market ought to be able to operate unhindered so this sort of thing can continue to facilitate the movement of funds around the country. I don't understand that reasoning, in light of the enormous deposit insurance risk I believe will result.

To permit the continued growth in federally guaranteed brokered funds, layered on top of those deposits obtained by depository institutions through their own marketing efforts -- all of which would be fully underwritten for risk by the FSLIC and FDIC --would be very poor public policy indeed. I say this because the total reserves of both deposit insurance funds is slightly over $20 billion. That is a tiny fraction of the total growth in brokered deposits alone which we envision ahead. Indeed, it must be recognized that today -- not out into the future, but today -- a substantial part of the $7 billion in reserves of the deposit insurance fund I head will be required to pay for liquidations and costly assisted mergers we can foresee or can expect down the pike in 1984 alone, most of them as a consequence of the brokered money phenomenon.

Does it make any sense whatsoever -- especially when the growth of third-party brokered funds is only in its infancy, compared to where we see this taking us several years out -- to expect these tiny insurance funds to underwrite the vastness, yes the enormity, of risk posed by such growth in the future.

In my view, allowing this to happen could either result ultimately in destroying the funds themselves, or by threatening to exhaust the resources of the insurance funds sooner or later the situation would require substantial infusions of funds from the U.S. Treasury, and hence the nation's taxpayers. It is difficult for me to understand the "serious reservations" of some, given the serious adverse impact I believe this will have on the deposit insurance system in the future, if we fail to rein in very substantially the unfettered growth we are witnessing in brokered funds activities.

At the end of September, the ratio of FSLIC reserves to deposits at FSLIC-insured institutions had dropped to 1.1 percent. This reserve level has deteriorated steadily during the past decade. Indeed, in 1970, the ratio was 2% -- by historical standards far higher than today. Given the nature of the problems the FSLIC is now facing as a result of brokered funds activities, there is no reason to expect any strengthening of this reserves-to-deposits ratio in the foreseeable future -- unless the problem is addressed head-on, and soon.

The last time the reserves-to-deposits ratio declined to under one percent was in the early 60s, which prompted the Congress to establish a costly secondary reserve additional assessment premium on savings institutions in 1962.

The Bank Board's projections demonstrate that were the present rate of growth in third-party brokered deposits to continue, the current ratio would likely drop somewhat below one percent in the next several years. This, in turn, would surely prompt imposition of additional premium assessments on FSLIC-insured institutions in order to merely bring the ratio back to what it is today, which already is well below historic levels. This would be very costly to our savings institutions, involving billions of additional dollars in premium assessments. These higher premium assessments would apply across-the-board, to every one of our institutions, whether or not an institution chose to use third-party brokered deposits. Again, this is a very likely scenario in the event the growth of such brokered deposits is not reined in very substantially. Let me assure you that the Bank Board will take whatever action may be necessary to assure that an appropriate ratio of FSLIC reserves-to-total deposits is maintained to safeguard the integrity of the deposit insurance fund.

I would remind you that it is the insured institution which is called upon to pay FSLIC insurance premiums. The money broker never pays a penny in premiums.

One of the concerns some institutions have expressed is that the proposed rule would inhibit them from using brokered funds with longer term maturities to restructure their asset-liability portfolios. This apparently is based on the premise that brokered money, at varying maturities, is somehow less costly than Federal Home Loan Bank advances.

A study made recently by the Office of Finance of the Federal Home Loan Banks shows that the net cost of advances to a member institution -- after factoring in the cost of commission charges, insurance premium costs and reserve requirements associated with deposit growth -- is comparable to, and often can be less than, the net cost of third-party brokered money to the institution, at any maturity.

The only conceivable advantage to the institution in choosing brokered deposits is that the money broker places his funds -- no questions asked.

The Federal Home Loan Bank does ask the member seeking an advance how the funds are going to be used, particularly in the case of larger advances.

The money broker has no reason to ask that question. And why should he? He can place the funds, and then forget them until rollover time comes. After all, the funds are fully insured by the FSLIC. Not to worry.

On the other hand, the Federal Home Loan Bank wants to be certain that its advance will be repaid by the institution, just as any prudent lender does when making a loan. How a Federal Home Loan Bank advance will be used is a question some institutions apparently would prefer not to have to answer -- and hence a compelling reason for some institutions to choose brokered deposits, no questions asked!

If the growth in third-party money brokerage were to continue at the rate we are now seeing, it would not be very long before the Federal Home Loan Banks would find that the magnitude of taking up the slack, by substituting their own advances, at least temporarily for maturing brokered CD packages, could be beyond the bank system's ability to quickly meet.

I am not suggesting here that such advances would be the only fund raising alternative. Clearly aggressive solicitation of retail deposits, subordinated debt, mortgage-backed bonds and a variety of other financial instruments would be available to institutions for obtaining funds in large demoninations in the money markets.

The total volume in brokered funds at FSLIC-insured institutions is still within the range of the Federal Home Loan Banks' ability to fill in very adequately with advances the void caused by maturing brokered CDs. However, were the volume of money brokered CDs to double or triple -- which we believe it would in the next year or so without the kind of action the proposed rule contemplates -- then the burden on the Federal Home Loan Banks would be far greater and it would be much more difficult to fill any such void because of the magnitude of brokered deposits.

Naturally, the Federal Home Loan Banks are going to exercise prudence, as they always do, when advances are applied for, and extended to member institutions. Again, this contrasts markedly with the brokered funds transaction where federal deposit insurance ends up underwriting the entire risk.

With respect to arguments that brokered-funds with longer term maturities help institutions to restructure portfolios, I would merely say that I have been in the forefront of efforts to urge and help facilitate portfolio restructuring at institutions we regulate. This is precisely why the Federal Home Loan Banks have been authorized by the Bank Board to make advances with maturities of up to 20 years. Indeed, funds with long-term maturities are within a larger stable of available restructuring tools, including Federal Home Loan Bank advances, wider use of the adjustable rate mortgage and the collateralized mortgage obligation programs of Freddie Mac.

Later this week, the Bank Board will unveil the details of yet another new restructuring tool. The new program will enable Federal Home Loan Bank member institutions to engage in interest rate swaps, either with the Federal Home Loan Banks or through them.

Because I touched several moments ago on the subject of maturing CDs placed by third-party money brokers at FSLIC-insured institutions, I want to share with you my deep concerns about what could, and probably would, occur at rollover time out into the future, assuming the continued rate of growth of third-party brokered money. It is eminently fair to ask: what would likely happen to the institution which became more and more reliant on the broker for funds several years from now? We already have been told of instances where money brokers are actually pricing the funds they amass themselves, rather than the recipient savings institution.

I am deeply concerned that at rollover time out in the future, the money broker will be so glued into the driver's seat that he will be able to dictate higher rates and terms for his CDs. Should we not contemplate the very real possibility that this would cause institutions to become hostages to money brokerage firms in connection with rates and terms for brokered funds out into the future? In that event, the money broker would be in the position of being able to literally manage the liability side of the insured institution, and conceivably even the asset side. Such a scenario, given the fact that there is no incentive whatsoever for the deposit broker entity to practice due diligence -- because all the funds it places at any insured institution, however weak the institution may be, are fully guaranteed -- is one of the most deeply troubling aspects of the entire brokered funds issue.

Early on in my remarks here, I mentioned the cost of regulation which depository institutions must bear. In stark contrast, the third-party money broker bears no such cost whatsoever.

Perhaps the most fundamental reason behind the strong regulatory burden depository institutions must shoulder is that they have specifically been assigned a wide range of public policy objectives by the Congress. They are required to meet the depositor and investment needs of the communities they serve.

Depository institutions, operating as fiduciaries of the public, are expected to meet a long list of requirements which derive from both statutory and regulatory guidelines, and which are intended to achieve compliance with safety and soundness criteria as well as other Congressionally-established objectives.

Cost estimates of compliance with Bank Board reporting requirements suggest that FSLIC-insured institutions spend 1.8 million hours per year in this endeavor alone. An indirect cost of the regulatory burden on depository institutions is interest income they must forego on non-interest bearing reserves held with the Federal Reserve. If interst on the $37.2 billion in such reserves (as of September 30, 1983) had been paid to institutions at the rate of 11 percent, depository institutions would have earned an additional $4.1 billion last year.

In addition, financial institutions must bear the direct cost of the regulatory system. The estimated 1983 budgets for the Federal Home Loan Bank system, the Federal Reserve system, the FDIC and the National Credit Union Administration totaled more than $1.3 billion.

The cost of regulation to depository institutions is very substantial indeed. The third-party money broker bears no such burden.

In a January 18 article in the New York Times by Reporter Michael Blumstein, he said: "Like a tidal wave pressing against a seawall, the securities industry is on the verge of crashing through the banking industry's territory. One of the securities industry's main goals is federal deposit insurance. Since December, 1982, when banks and thrift units began offering federally-insured money market deposit accounts, the securities industry has been nothing short of a fanatic in its effort to break through the banking barrier."

In this regard, let me just say that if the big securities firms and money brokerage firms want to continue to sell federally-insured deposits, and therefore assume the same regulatory burdens our depository institutions must endure -- including the same level of cost for compliance, supervision, examination, record-keeping, reserve requirements, financial reporting requirements, federal deposit insurance premiums and a very long list of other relatively onerous regulatory mandates -- then perhaps it might be worthwhile to sit down and talk about federal deposit insurance with them.

Far be it for me to wish such regulation on them.

However, were they to decide, as I suspect they would, to opt against the kind of regulation banks and savings institutions must comply with and pay for, then I think you can understand how it is I question the appropriateness of skimming off the top of all of their federally guaranteed transactions a handsome profit -- without having to accept any responsibility whatsoever as to where their brokered funds are placed or how the funds are used.

In my view, this amounts to an unintended federal subsidy which is being reaped increasingly by unregulated entities which are operating outside the scope of what public policy ever intended and also are riding high -- and free of charge, compared to the regulatory-imposed cost of doing business as a bank or savings institution -- atop the federal deposit insurance system.

And all this is taking place under circumstances in which the federal deposit insurance agencies must bear the full consequences of the additional risk the money brokers are increasingly layering on to the deposit insurance system.

Speaking as the operating head of the Federal Savings and Loan Insurance Corporation, with a solemn duty to protect the safety and soundness of the fund, I can find no public policy virtue in permitting this situation to continue in the future to further exacerbate -- yes further jeopardize -- the safety and soundness of the federal deposit insurance system.

In my view, the Congress has the prerogative, if it chooses to exercise that prerogative, to alter what has been in my mind its intent with respect to what kind of entities can and should market federal deposit insurance. Again, on the basis of my understanding of congressional intent, going back to the early 30s, the sale of federal deposit insurance was assigned exclusively by the Congress to depository institutions and to no other kind of financial entity. Were the Congress to choose to change its approach through a new statute permitting these money brokerage firms to engage in marketing the federal deposit insurance seal, I am sure that such an action would take into account all the concerns I have raised in my remarks today before such a decision were made.

It is extremely important that members of Congress, savings institutions, banks, the money broker organizations and the public fully understand why it was so important for the FDIC and the Bank Board to issue the proposed rule of January 16.

Let me assure you that one of the key arguments some money brokerage firms have made -- that they are merely sending off to depository institutions excess funds they hold temporarily until other investments can be found -- is simply not true. The largest money brokerage firms in the country are vigorously marketing -- in full page ads and on television -- FDIC and FSLIC-insured accounts of varying maturities. In no way are such activities related to the temporary placement of excess monies in their firms by clients seeking more conventional risk-based investments. Anyone who believes such stories will also believe in fairy tales.

Based on what I know to be true, and based on what is reasonable to expect in the future, the kind of rule the Bank Board and FDIC have proposed has been placed on the public table none too soon.

The proposal we have made is not " a giant step backward," as some claim. It is a giant step forward, in order to come to grips with the magnitude of risk we will face at the federal deposit insurance agencies in the future -- unless action is taken soon to substantially restrain the skyrocketing activity in third-party money brokerage, and all of it fully underwritten for risk by the comparatively extremely limited resources of two finite, yes relatively very tiny, federal deposit insurance funds.

Nor is the proposed rule a "sledgehammer" approach, except to those entities which wish to ignore, for their own reasons, the implications of such money brokerage activity for the safety and soundness of the federal deposit insurance funds, which I -- not they -- do have to worry about and am determined to try to protect, consistent with my mandate from the Congress.

Nor does the proposed rule constitute "regulatory overkill" -- a favorite knee-jerk colloquialism used by those who choose to disagree. The proposed rule recognizes the extreme seriousness of the problem we face at the deposit insurance agencies and seeks to confront the issue, and the consequences of inaction, head-on.

Nor does the proposal "diminish" in any way the value of the thrift charter. But, I can assure you that any threat to the future viability of the federal deposit insurance system would indeed have the effect of diminishing the thrift charter.

In conclusion, it is imperative that all the parties to this issue, examine very carefully the stakes involved -- were nothing to be done to deal with the problem. What the Bank Board and the FDIC have proposed is the one approach now available to meet the problem head-on.

It is important for depository institutions to understand how their very character as institutions could be radically altered if the problem is not dealt with while there is still time.

It is important that these institutions fully understand how inaction or failure to come to grips with the implications of the issue could jeopardize the future viability of the deposit insurance system.

It is important for the Congress to recognize the possibility of having to cause an infusion of funds from the Treasury to back the credibility of the deposit insurance system, at some point down the road -- should the Bank Board and FDIC fail to deal with this issue.

Surely, extending the risk of federal deposit insurance well beyond the confines of depository institutions and into the infinite recesses of our financial system -- through the kind, and volume, of money brokerage activities we would envision without firm, corrective action -- could result in such Treasury infusions in the future.

Finally, and most important of all, the American public should understand the stakes involved for a depository institutions system and a federal deposit insurance system which have, together, served the banking, deposit convenience, community and business and housing credit needs of Main Street America so well down through the years.

For this opportunity to lead you through my concerns, I thank you very much.

# # # #

"BROKERED FUNDS: A SPREADING CANCER ON THE FEDERAL DEPOSIT INSURANCE SYSTEM"

REMARKS PREPARED FOR DELIVERY

BEFORE

A JOINT MEETING OF THE BOARDS OF DIRECTORS

FEDERAL HOME LOAN BANKS OF NEW YORK AND ATLANTA

BY

EDWIN J. GRAY, CHAIRMAN

FEDERAL HOME LOAN BANK BOARD

AT

DORADO, PUERTO RICO

FEBRUARY 11, 1984

Thank you very much.

I want to focus again on the brokered funds issue which I consider to be critical in its implications for the future of the nation's depository institutions and the federal deposit insurance system.

Failure to come to grips with this issue by you in the industry, and by those of us who are entrusted by the Congress to head, manage and protect the current and future safety and soundness of the federal deposit insurance system, would, in my view, amount to a dereliction of duty.

The implications of the type and nature of third-party, federally-guaranteed and federally-subsidized money brokering we are now witnessing — for the future of America's depository institutions as we have known them, and for the future of the federal deposit insurance system, itself — are sobering, indeed.

The Economic Report of the President, which was sent to the Congress on February 2 of this year makes very clear the critically important role played by the Federal Deposit Insurance System. The Report says: "Two types of governmental institutions (The Federal Deposit Insurance System and the Federal Reserve System) now serve to prevent a financial panic from cascading into a collapse of the banking system." The

Report says the FDIC and FSLIC "provide deposit insurance so that the failure of one unhealthy institution will not produce panic runs on healthy institutions."

In my view, the skyrocketing growth of the third-party, federally guaranteed activity of the money brokerage industry represents a growing cancer on the federal deposit insurance system which, again, the President's Economic Report to the Congress says "...serve(s) to prevent a financial panic from cascading into a collapse of the banking system."

The proliferation of federally-guaranteed and federally-sudsidized brokered funds activity we are seeing is exponential. It is growing by leaps and bounds. In my view, it is out of control. Yet, there are some in the money brokerage community, who, it would appear, would have you believe, because it apparently suits their own interests, that third party money brokering poses little or no danger to the federal deposit insurance system.

It is understandable, of course, that those who apparently would seek to legitimize the unabated sale of federal deposit insurance by non-depository institutions, also are apparently seeking to minimize the effects of this kind of federally-guaranteed third-party money brokerage activity on the deposit insurance funds.

On the other hand, as the operating head of the FSLIC, it is my sworn duty to protect the safety and soundness of the insurance fund. It is a responsibility I take very seriously.

In my view, it would be wrong to play chicken with the future viability of the federal deposit insurance system simply because those who have no stake whatsoever in the future of the system may choose to conveniently articulate self-serving arguments at press conferences in order to apparently justify the continuation of such an activity. I will touch more directly on this later in my remarks.

I believe that unless the third-party, federally-insured money broker activity we are witnessing is reined in very substantially, and very soon, it will develop such a constituency that the Congress will find it exceedingly difficult to deal with in the future.

The proposed rule issued by the Bank Board and the FDIC on January 16 was, according to the legal staffs of both agencies, the only one available based on the insurance statutes themselves. That was the reason the rule was proposed. On that basis, it has seemed to me to be the best available alternative we have yet seen. On the other hand, the comment period is intended to permit a variety of views and alternatives to be offered. We, of course, will examine all the comments we receive very carefully and weigh them before coming to any final decision on this issue. Let me emphasize once again, however, that the only statutorily-derived alternative we had, on the basis of the staffs' findings, was the one based on the insurance statutes, which was embodied in the proposed rule.

The consequences of the federally-insured activities of third-party money brokers already are taking a heavy toll on institutions. And, as such, these activities already have begun to jeopardize the safety and soundness of the federal deposit insurance funds.

Please bear in mind that this new wave of money broker activity is still only in its infancy.

Without firm, decisive and expeditious remedial action, I believe that the future viability of the federal deposit insurance system could be gravely threatened -- so much so that only massive infusions from the treasury, and hence the U.S. taxpayer -- could well be required to support the deposit insurance function which, heretofore, has been funded by premiums paid by depository institutions themselves.

This may sound far-fetched. But I can assure you that the ease of access to third-party money broker-supplied funds by depository institutions willing to pay the highest price for the funds is converting too many healthy savings institutions and banks into soon-to-be failures.

The money broker delivers the cash, instantaneously by wire transfer -- no questions asked. The funds are totally underwritten by the federal deposit insurance system. The money broker sleeps well. He knows the funds are insured. He has made sure of that.

One large money broker advertises: "We advise the (depository) institutions as to what rate they must pay (for CDs) in order to become competitive. This translates to offering you the most aggressive rates nationwide." Another ad in the Wall Street Journal this month features a savings and loan executive saying: "Within one month, we grew from $2 million to $29 million. Within three months we were up to $50 million." The executive boasts in the ad that such money brokering "enables institutions such as (ours) to accomplish what we set out to do. Grow."

Another advertisement, by yet another money broker, brags that its account "had a yield of 9.70 percent. The national average for banks was just 8.55 percent...," its ad in a major daily newspaper says.

And, who pays these high rates for funds? Who is at the other end of the transaction being "advised...as to what rate they must pay" for CDs? FSLIC and FDIC-insured savings institutions and banks -- and all too often, in the end, the federal deposit insurance funds, themselves.

The money broker has packaged the funds into neat bundles of $100,000 or less. He does this everyday for a fee which is paid by the depository institutions. A simple phone call produces the funds immediately. No need for the broker to practice any sort of due diligence. The funds are totally federally insured. Not to worry!

Now it does become our worry! It is the FDIC and FSLIC which must pick up the pieces -- when the institutions fail.

Lured by easy access to such funds, too many savings institutions which were healthy not too long ago -- institutions which have grown at lightning speed because the broker was ready at a moment's notice to produce the funds -- are turning into disasters for the FSLIC.

In too many cases, the money-broker-fed rapid growth in deposits -- which translates into hurry-up risky investments, some of which may have been lined up by the money broker entity, itself -- occurs so fast that we frequently aren't able to catch up with it in the examination process until it's too late.

It is important here to recognize two points:

First, what for the FSLIC were formerly earnings spread problems -- that is, underwater loans backed by good assets and, therefore, cases which, while difficult, were solvable -- have, in recent months, become far more costly problems involving bad assets due to risky investments.

Secondly, the impetus to make these bad loans derives from incredibly easy access to virtually unlimited amounts of federally-insured funds from money brokers.

In November, the FDIC and the Bank Board took joint action to limit access by troubled federally insured institutions to brokered money. This was an interim measure, pending the development of a more comprehensive approach to the problem. Subsequently, the two agencies issued a joint advance notice of rulemaking intended to explore ways to deal with the problem in an overall way.

Again, in mid-January, after weeks of work by the staffs of the FDIC and the Bank Board, we jointly proposed the comprehensive, more definitive approach I've already mentioned in order to come to grips with these problems in their entirety.

You should know that an effort was made by the money brokerage industry to torpedo the issuance of even a proposed rule. Nevertheless, in spite of the heavy pressure, the rule was issued for public comment.

The failure of the money brokers to squelch the mere issuance of a proposed rule has subsequently led to an intense lobbying effort on their part. Besides Members of Congress, we understand the money broker operators have targeted depository institutions with a myriad of self-serving horror stories as to what would happen to them if the proposed rule were to be adopted, essentially as proposed.

From reports we have heard, the brokers are saying the rule, if adopted, would keep savings institutions from restructuring their portfolios, and that the institutions themselves would no longer be able to raise deposits in sufficient volumes to satisfy prudent lending and operating requirements.

While we do recognize there would be a period of adjustment for some institutions during such a transition period, the truth is that the Federal Home Loan Banks, through their variable-maturity advances and other programs, and the use of a variety of instruments already available to depository institutions in the marketplace, would help to substantially ameliorate such problems.

Further, were the proposed rule to be adopted, it would provide virtually exclusive right to the use of the FSLIC and FDIC insurance seals to savings institutions and banks, themselves. The marketing tools these "seals of safety" offer to depository institutions would enable institutions to capture a very sizeable share of the deposit market which is now going, by default, to the money brokers which are marketing FSLIC and FDIC insurance through a variety of massive advertising campaigns, like the ones I've mentioned, across the nation.

I do not believe the Congress ever intended that federal deposit insurance would be used by anyone other than small savers -- working men and women, families, the elderly and the young. That was what the federal deposit insurance system was all about when it was concurrently assigned exclusively to banks and savings institutions a half century ago.

President Roosevelt stated it this way, on May 14, 1934, in his message to Congress urging passage of the legislation which created the FSLIC:

"These (savings) institutions are custodians of funds from small savers, and it is essential they should be given every protection." He went on to say, "insurance of this type is necessary in order to arrest any further drain on these institutions.".

In that same year, the then-General Counsel of the Bank Board, Horace Russell, said: "The object to be accomplished by the suggested insurance... is primarily to stabilize confidence in home financing institutions...".

Federal deposit insurance has always been intended by Congress, to bolster public confidence in the stability and safety of America's depository institutions. It was never meant for, it was never assigned to, any other kind of financial intermediary by the Congress, itself.

Indeed, federal deposit insurance was never meant to be an end in itself. Nor was it meant, in my view, to insure deposits marketed by any kind of financial entity -- other than those marketed by depository institutions, themselves.

It was the device, the scheme by which Congress, sought to maintain, instill and reinstill public confidence in the stability and safety of America's depository institutions, alone.

And Why?

Because as regulated institutions, banks and savings institutions have been, and are, legally defined and Congressionally-mandated private-sector instrumentalities of public policy.

This is not true of the money broker operators who -- in their quest for what is, in effect, a government-subsidized federal guarantee, on which they predicate their self-proclaimed so-called public policy role -- are now apparently seeking to legitimize what is, in fact, nothing more than back-door access to the federal deposit insurance system.

Were the Congress to desire to establish some form of federal insurance for the money broker operator entity and its operations, then the Congress would have the prerogative, through the legislative process, to do so whenever it so desired.

But the Congress has never chosen to do so. Nor did the Congress choose, when it might have done so, to extend such insurance to the money market mutual funds, which are similar, in this regard, to such money broker operations. In my view, this was a very wise decision.

Neither of these kinds of financial intermediaries are Congressionally-defined instrumentalities of public policy. Some money broker operators are apparently seeking to suggest that they are driven to achieve the same sort of high public policy purpose, whether or not it is so defined. However, in my view, an observer will soon recognize that they would not be engaging in this activity -- this federally guaranteed, and, yes, federally subsidized activity -- were it not for the fee they earn on the transaction.

As a champion of the free enterprise system, I do not for a minute oppose their desire to earn a fee for their work.

It is the unintended use of federal deposit insurance, and what is effectively a federal subsidy which goes with it, that I question very seriously. It is the consequences of this unintended activity for the federal deposit insurance system that concern me so very deeply.

For the money broker, this amounts to riding high, atop the federal deposit insurance system, and skimming off a handsome profit on transactions, without having to pay the high cost of regulation or meet a host of public policy-directed obligations -- not the least of which are to serve the deposit and investment needs of local citizens in the community -- which banks and savings institutions are required to do by law every day.

Incidently, the money broker never pays a penny in premiums to the FSLIC or FDIC. Only savings institutions and banks are obligated to pay that cost, which amounts to billions of dollars in premium assessments.

I'm afraid that in their apparent quest for back-door access to federal deposit insurance, these money brokerage people --including Wall Street firms and others who traditionally have sung the praises of enterpreneurship, risk and reward -- have chosen to sublimate those laudible economic principles to the pursuit of a fee. And that fee turns out to be based entirely on an unintended government subsidy to them

-- again, because they pay none of the high costs of government regulation endemic to the operations of federally insured depository institutions as Congressionally-defined private sector instrumentalities of public policy.

As I see it, those money broker entities which have traditionally and so ardently proclaimed the virtues of the free market, yes those who so admirably have advocated the entrepreneurial virtues of risk and reward, are now doing what I believe amounts to an about-face on the money broker issue by choosing, for their own reasons, to confuse their high free market principles with the newly discovered government guarantee represented by federal deposit insurance.

Again in my view, for them to avail themselves of this unintended government subsidy, on which they are predicating their insured-money brokering business, is both improper and well beyond the scope of purpose federal deposit insurance should serve.

I marvel at the arguments some of the largest money brokers are using. They trot out charts at press conferences to show that most of the money brokerage activity going on is in uninsured institutional funds. Their own charts, their own figures, seek to prove that the federally-insured money brokerage activities they are engaged in are relatively small. Yet, in the very next breath, they claim that the proposed rule the Bank Board and FDIC have put out for comment would, if adopted, put them out of business.

As I said, this new-wave money-broker industry is growing by leaps and bounds. Absent adequate, decisive and expeditious corrective action, there is no credible reason to assure that the federally guaranteed and subsidized growth we're witnessing on the part of the money broker operators won't continue, unabated, out into the future.

To expect the federal deposit insurance system to fully underwrite the additional, new and skyrocketing risk burden represented by the money brokers' government-guaranteed and government subsidized money brokerage activities -- layered on top of the already huge insurance burden the FSLIC and FDIC must bear for deposits gathered directly by savings institutions and banks, themselves -- would, in my view, be questionable if not very poor public policy, indeed.

Ask yourselves this question? Can, and should, two insurance companies -- in this case, the FSLIC and FDIC, with total aggregate reserves of slightly over $20 billion -- possibly be expected to cover the risk of trillions of dollars in self-generated federally-insured deposits by savings institutions and banks, plus the mushrooming additional billions, if not trillions of dollars in new risk, posed down the road by the skyrocketing federally-insured activities of the money brokerage industry?

Thank you very much.

"BROKERED FUNDS: A SPREADING CANCER ON THE FEDERAL DEPOSIT INSURANCE SYSTEM"

AN ADDRESS BY

EDWIN J. GRAY, CHAIRMAN

FEDERAL HOME LOAN BANK BOARD

BEFORE

THE BANKING LEADERSHIP CONFERENCE

OF THE

AMERICAN BANKERS ASSOCIATION

WASHINGTON, D.C.

FEBRUARY 16, 1984

Thank you very much.

For one who has been perceived by the commercial banking community as being so closely associated with savings institutions over the past several years, I hope you will see me today as an advocate of the nation's thrifts and banks.

I come before you with a thoroughly Main Street mentality, and as the operating head of the FSLIC. I came to Washington, in my present capacity, to protect the safety and soundness of the federal deposit insurance system.

In this regard, I want to focus my remarks on the brokered funds issue which I consider to be critical in its implications for the future of the nation's depository institutions and the federal deposit insurance system.

Failure to come to grips with this issue by you in the banking industry, and by those of us who are entrusted by the Congress to head, manage and protect the current and future safety and soundness of the federal deposit insurance system, would in my view, amount to a dereliction of duty.

The implications of the type and nature of third-party, federally-guaranteed and federally-subsidized money brokering we are now witnessing -- for the future of America's depository institutions as we have known them, and for the federal deposit insurance system, itself -- are sobering, indeed.

The Economic Report of the President, which was sent to the Congress on February 2nd, makes very clear the critically important role played by the federal deposit insurance system.

The report says, "two types of governmental institutions (the Federal Deposit Insurance System and the Federal Reserve System) now serve to prevent a financial panic from cascading into a collapse of the banking system."

The report says the FDIC and FSLIC "provide deposit insurance so that the failure of one unhealthy institution will not produce panic runs on healthy institutions."

In my view, the skyrocketing growth of the third-party, federally-guaranteed activity of the money brokerage industry represents a spreading cancer on the federal deposit insurance system. This is the system which the Economic Report of the President says "serves to prevent a financial panic from cascading into a collapse of the banking system."

The proliferation of federally-guaranteed and, yes, federally-subsidized, brokered funds activity we are seeing is exponential.

It is growing by leaps and bounds. In my view, it is out of control.

Yet, there are some in the money brokerage community who would have you believe -- because it suits their own interests -- that third-party money brokering poses little or no danger to the federal deposit insurance system.

It is understandable, of course, that those who seek to legitimize the unabated sale of federal deposit insurance -- by non-depository institutions -- also apparently are seeking to minimize the effects of this kind of federally-guaranteed, third-party money brokerage activity on the deposit insurance funds.

On the other hand, as the operating head of the FSLIC, it is my sworn duty to protect the safety and soundness of the insurance fund. It is a responsibility I take very seriously.

In my view, it would be wrong -- dead wrong -- to play chicken with the future viability of the federal deposit insurance system, simply because those who have no stake, whatsoever, in the future of the system, choose to conveniently articulate self-serving arguments at press conferences in order to justify the continuation, indeed the mushrooming activity, represented by today's kind of federally-insured money brokering.

I believe that unless the third-party, federally-insured money broker activity we are witnessing is reined in very substantially, and very soon, it will develop such a constituency that the Congress will find it very difficult to deal with, in the future.

The proposed rule issued by the Bank Board and the FDIC on January 16th was, according to the legal staffs of both agencies, the only one available based on the insurance statutes themselves. That was the reason the rule was proposed.

On that basis, it has seemed to me to be the best available alternative we have seen.

On the other hand, the comment period is intended to permit a variety of views and alternatives to be offered. We, of course, will examine all the comments we receive very carefully, and weigh them before coming to any final decision on this issue.

The consequences of the federally-insured activities of third-party money brokers already are taking a heavy toll on thrift institutions. And, as such, these activities already have begun to jeopardize the safety and soundness of the deposit insurance fund.

Please bear in mind that this new wave of money broker activity is still only in its infancy.

Without firm, decisive and expeditious remedial action, I believe the future viability of the federal deposit insurance system could be gravely threatened -- so much so that only massive infusions from the treasury, and hence the U.S. taxpayer -- could well be required to support the deposit insurance function which, heretofore, has been funded by premiums paid by depository institutions, themselves.

I am not saying it would happen tomorrow, but rather by and by as the sale of federal deposit insurance by money brokers would pile massive new risk on the system.

Let there be no mistake about the money brokers' intentions. Michael Blumstein of the New York Times put it succinctly in a recent article. He said: "like a tidal wave pressing against a sea-wall, the securities industry is on the verge of crashing through the banking industry's territory. One of the securities industry's main goals is federal deposit insurance."

Today, the ease of access to third-party money broker-supplied funds by depository institutions willing to pay the highest price for the funds is converting too many healthy savings institutions and banks into soon-to-be failures.

The money broker delivers the cash, instantaneously -- by wire transfer. No questions asked. The money broker sleeps well. He knows the funds are insured. He has made sure of that.

One large money broker advertises: "we advise the (depository) institutions as to what rate they must pay (for CDs) in order to become competitive. This translates to offering you the most aggressive rates nationwide," the ad says.

Another ad in the Wall Street Journal this month features a savings and loan executive saying: "within one month, we grew from two million dollars to 29 million. Within three months we were up to 50 million."

The executive boasts in the ad that such money brokering "enables institutions such as (his) to accomplish what we set out to do. Grow."

This is the mentality which, because of the easy, instantaneous access to these brokered funds, is driving too many institutions to lightning fast growth in deposits. So fast, in fact, that in too many cases, even our examiners can't keep up with it. The bad loans, the bad assets which ensue from this scenario end up on the doorstep of the FSLIC. When bad assets are the problem, solutions are far more costly to the deposit insurance fund.

Another advertisement, by yet another money broker, brags that its account "had a yield of 9.7 percent." It compares this to the national average for banks which it cites as 8.55 percent: 115 basis points less.

And who pays these rates to the money broker for funds? Who is at the other end of the transaction, being -- as the ad says -- "advised...as to what rate they must pay for CDs?" FSLIC and FDIC-insured savings institutions and banks. And, all too often, in the end, the federal deposit insurance funds, themselves.

The money broker has packaged the funds into neat bundles of 100,000 or less. He does this every day for a fee which is paid by the depository institution. A simple phone call produces the funds immediately. No need for the broker to practice any sort of due diligence, whatsoever. The funds are totally insured. Not to worry.

Now it does become our worry! As I said before, it is the FDIC and FSLIC which must pick up the pieces -- when the institutions fail.

Lured by easy access to the funds, too many savings institutions which were healthy not too long ago are turning into disasters for the FSLIC.

In too many cases, the money broker-fed rapid growth in deposits -- which translates into hurry-up, risky investments, some of which may have been lined up by the money broker operator -- occurs so fast that we frequently aren't able to catch up with it in the examination process, until it's too late.

Here, it's important to recognize two points.

First, what for the FSLIC were formerly earnings spread problems -- that is underwater loans backed by good assets and, therefore, cases which, while difficult, were solvable -- have, in recent months, become these far more costly problems, involving, again, bad assets, due to very risky investments.

Second, the impetus to make these bad loans derives from the incredibly easy access to virtually unlimited amounts of federally-insured funds from money brokers.

In November, the FDIC and the Bank Board took joint action to limit access by troubled, federally-insured institutions to brokered money. This was an interim measure, pending the development of a more comprehensive approach to the problem.

Subsequently, the two agencies issued a joint advance notice of rulemaking intended to explore ways to deal with the problem in an overall way.

Again, in mid-January, after weeks of work by the staffs of the FDIC and the Bank Board, we jointly proposed the comprehensive, more definitive approach I've already mentioned in order to come to grips with these problems in their entirety.

You should know that an effort was made by the money brokerage industry to torpedo the issuance of even a proposed rule. Nevertheless, in spite of the heavy pressure, the rule was issued for public comment.

The failure of the money brokers to squelch the mere issuance of a proposed rule has subsequently led to an intense lobbying effort on their part.

Besides zeroing in on Members of Congress, we understand the money broker operators have targeted depository institutions with a myriad of self-serving horror stories as to what would happen to them if the proposed rule were to be adopted, essentially as proposed.

From reports we have heard, the brokers are saying the rule, if adopted, would keep savings institutions from restructuring their portfolios, and that banks and savings institutions would no longer be able to raise deposits in sufficient volumes to satisfy prudent lending and operating requirements.

While we do recognize there would be a period of adjustment for some institutions during such a transition period, the truth is that for thrifts, the Federal Home Loan Banks -- through their variable-maturity advances and other programs -- and the use of a variety of instruments already available to depository institutions in the marketplace, would help to substantially ameliorate such problems.

Further, were the proposed rule to be adopted, it would provide virtually exclusive right to the use of the FDIC and FSLIC insurance seals -- to savings institutions and banks, themselves.

The marketing tools these "seals of safety" offer to depository institutions would, I believe, enable institutions to capture a very sizeable share of the deposit market which is now going, by default, to the money brokers which are marketing FSLIC and FDIC insurance through a variety of massive advertising campaigns, like the ones I've mentioned, across the nation.

I do not believe the Congress ever intended that federal deposit insurance would be used by anyone other than small savers -- working men and women, families, the elderly and the young.

That was what the federal deposit insurance system was all about when it was concurrently assigned exclusively to banks and savings institutions a half-century ago.

President Roosevelt stated it this way, on May 14, 1934, in his message urging passage of the legislation which created the FSLIC: "these (savings) institutions are custodians of funds for small savers, and it is essential they should be given every protection." He went on to say, "insurance of this type is necessary in order to arrest any further drain on these institutions."

In that same year, the then-General Counsel of the Bank Board, Horace Russell, said: "the object to be accomplished by the suggested insurance...is primarily to stabilize confidence in home financing institutions."

Federal deposit insurance has always been intended by Congress to bolster public confidence in the stability and safety of America's depository institutions. It was never meant for, it was never assigned to, any other kind of financial intermediary by the Congress, itself.

Indeed, federal deposit insurance was never meant to be an end in itself. Nor was it meant, in my view, to insure deposits marketed by any kind of financial entity -- other than those marketed by depository institutions, themselves.

The purpose was not to insure deposits. Insurance of accounts was the scheme the Congress chose in order to accomplish its stated, indeed its fundamental and overriding purpose: to bolster public confidence in the stability of the nation's depository institutions.

In my view, this is a very critical point because there are those -- particularly in the third-party money brokerage industry --who would have you believe that the purpose of federal deposit insurance was to insure accounts. Yes, they do claim, in one of the most artful fictional rewrites of history as to the intent of the Congress, that the purpose of federal deposit insurance was to insure accounts -- their accounts. They choose to do this frequently. It runs through their literature. They choose to make this erroneous claim because it just happens to serve their own purposes, their own newly discovered claim on this latter day Comstock Lode.

For if it can be successfully argued that the insurance of accounts was the main reason, in and of itself, for Congress' decision to create federal deposit insurance, then it might also be logically argued that such insurance ought no longer be the sole province of depository institutions.

A close reading of Congress' intent, when it established the deposit insurance funds, demonstrates very clearly that the assignment of such insurance to savings institutions and banks was to reinstill public confidence in America's depository institutions -- so that small savers would fetch their cash from under the mattress and put it back into their bank or savings institution.

Why am I dwelling on this point?

Because as regulated institutions, banks and savings institutions have been, and are, legally-defined and Congressionally-mandated private-sector instrumentalities of public policy.

This is not true of the money broker operators who -- in their quest for what is, in effect, a government-subsidized federal guarantee, on which they predicate their self-proclaimed so-called public policy role -- are now seeking to legitimize what is, in fact, nothing more than back-door access to the federal deposit insurance system.

Were the Congress to establish some form of federal insurance for the money broker community, then the Congress would have the prerogative to do so, at any time.

But, the Congress has, in fact, never chosen to do so. Nor did the Congress choose, when it might have done so, to extend such insurance to the money market mutual funds, which are similar, in this regard, to such money broker operations. In my view, this was a very wise decision..

Neither of these kinds of financial intermediaries are Congressionally-defined instrumentalities of public policy and, unlike bank and savings institutions, they need not bear the heavy cost of regulation. Indeed, they are not regulated at all.

Some money brokers apparently are seeking to suggest that they are, in fact, driven to achieve the same sort of high public policy purpose assigned to depository institutions, whether or not such a purpose is so defined by the Congress.

I am very skeptical of such claims.

I seriously doubt they would be engaging in the money brokering activity -- this federally guaranteed and, yes, federally subsidized activity -- were it not for the fee they earn on the transaction.

As a champion of the free enterprise system, myself, I do not for a minute oppose their desire to earn a fee for their work.

Rather, it is the unintended use of federal deposit insurance, and what is effectively a federal subsidy which goes with it, that I question very seriously. And, it is the consequences of this unintended activity for the present and future safety and soundness of the federal deposit insurance system that concern me so deeply

For the money broker, this amounts to riding high, atop the federal deposit insurance system, and skimming off a handsome profit on transactions, without having to pay the high cost of banking regulation or meet a host of public policy-directed obligations -- not the least of which are to serve the deposit and investment needs of local citizens in the community -- which banks and savings institutions are required to do -- by law -- every day.

Incidently, the money broker never pays a penny in premiums to the FDIC or FSLIC. Only savings institutions and banks are obligated to pay that cost, which amounts to many billions of dollars annually in premium assessments.

I'm afraid that in their apparent quest for back-door access to the government-subsidized federal guarantee represented by federal deposit insurance, these money broker people -- including Wall Street firms and others who traditionally have sung the praises of enterpreneurship, risk and reward -- have chosen to sublimate those laudible economic principles to the pursuit of a fee.

And, that fee turns out to be based entirely on an unintended government subsidy to them -- again, because they pay none of the high costs of government regulation endemic to the operations of federally-insured depository institutions as Congressionally-defined private sector instrumentalities of public policy.

As I see it, those money broker entities which have traditionally, and so ardently, proclaimed the virtues of the free market -- yes, those who so admirably have advocated the entrepreneurial virtues of risk and reward -- are now doing what I believe amounts to an about-face on the money broker issue by choosing, for their own reasons, to confuse their high free market principles with the newly discovered government guarantee represented by federal deposit insurance.

Again, in my view, for them to avail themselves of this unintended government subsidy, on which they are predicating their insured money brokering business, is both improper and is well beyond the scope of purpose federal deposit insurance should serve.

I marvel at the arguments some of the largest money brokers are using. They trout out charts at press conferences to show that most of the money brokerage activity going on is in uninsured institutional funds. Their own charts, their own figures, seek to prove that the federally-insured money brokerage activities they are engaged in are relatively small.

Yet, in the very next breath, they claim that the proposed rule the Bank Board and FDIC have put out for comment would, if adopted, put them out of business.

As I have said, this new wave of money brokering is growing by leaps and bounds. Absent adequate, decisive and expeditious corrective action, there is no credible reason to assume that the federally guaranteed and subsidized growth we're witnessing on the part of the money broker operators won't continue, upward and unabated, in the future.

To expect the federal deposit insurance system to fully underwrite the additional, new and skyrocketing risk burden represented by the money brokers' federally-guaranteed activities -- layered on top of the already huge burden the FSLIC and FDIC must bear for deposits gathered directly by savings institutions and banks, themselves -- would, in my view, be questionable if not very poor public policy, indeed.

Ask yourselves this question.

Can, and should, two insurance companies -- in this case, the FSLIC and FDIC, with total aggregate reserves of slightly over twenty billion dollars -- possibly be expected to cover the risk of trillions of dollars in self-generated, federally-insured deposits gathered by savings institutions and banks themselves,

plus

the mushrooming additional billions, if not ultimately trillions of dollars in new risk posed in the future by the skyrocketing federally-insured activities of the money brokerage industry?

In my view, it is simply wrong to play chicken with the future viability of the federal deposit insurance system in this manner.

Thank you very much.

CHAIRMAN GRAY'S ADDRESS
TO THE
NATIONAL COUNCIL OF
SAVINGS INSTITUTIONS' BOARD OF DIRECTORS

I want to thank all of you National Council Board Members for this opportunity to share with you my views and my concerns regarding brokered funds.

The Bank Board's Deputy General Counsel Tom Long and Brian Neuberger of the FSLIC are intimately familiar with these views and, for that matter, they are in an excellent position to answer any questions that you may have at the conclusion of my remarks.

I know that you will find Brian's review of the state of the FSLIC to be sobering, indeed.

I believe third-party, federally-guaranteed and yes, federally-subsidized money broker activities are a spreading cancer on the Federal Deposit Insurance System. They represent a direct threat to the present and future safety and soundness of Federal Deposit Insurance.

Now, for any institution represented here today that is not truly interested in the maintenance of a viable Federal Deposit Insurance System, my remarks may not have much meaning.

However, for those institutions which believe as I do, that Federal Deposit Insurance underlies the very credibility of their capacity to do business with the public, I hope they will pay very close attention to the strongly-held concerns I have.

At the outset, let me remind you that it is my sworn duty, as the operating head of the Federal Savings and Loan Insurance Corporation, to protect the safety and soundness of the Fund.

In the truest sense, it is your Fund. Each year, your institutions contribute sizable amounts of money through premium assessments to support the continued operation of the FSLIC.

The public trust I and my colleagues at the Bank Board must oversee on your behalf -- and on behalf of the public -- has been delegated to us through statute by the Congress of the United States. In all honesty, I would be derelict in my solemn duty to head, manage and protect the Fund if I failed to call to your attention the alarming manner in which third-party money-brokering activities are today laying the groundwork for the ultimate demise of savings institutions as we have known them, and for the Federal Deposit Insurance System, as we have known it for a half-century.

I am frankly shocked by the passivity -- indeed, misunderstanding as to the high stakes implications for the future of savings institutions which seems to be the case of many in the industry as we approach the money broker issue.

It is instructive to begin, I believe, by examining the straightforward language contained in the Economic Report of the President which was transmitted to the Congress only a month ago.

That language makes very clear the critically-important role played now, today, by the Federal Deposit Insurance System. The report says, "Two types of governmental institutions -- the Federal Deposit Insurance System and the Federal Reserve System -- now serve to prevent a financial panic from cascading into a collapse of the banking system."

The report goes on to say, "The FDIC and the FSLIC provide deposit insurance so that the failure of one healthy institution will not produce panic runs on healthy institutions."

Fifty years after President Roosevelt enacted the laws creating the FSLIC and FDIC, the Reagan Administration's own Economic Report echoes the intent of the Congress and the President, who served in the darkest days of the Great Depression.

It was President Roosevelt who stated, in his 1934 Message to Congress urging the creation of the FSLIC, these words: "These savings institutions are custodians of funds for small savers. Insurance of this type is necessary to arrest any further drain on these institutions."

Indeed, earlier in that same year, the then-General Counsel of the Federal Home Loan Bank Board, commented: "The object to be accomplished by the suggested FSLIC Insurance is primarily to stabilize confidence -- to stabilize confidence in home financing institutions."

Indeed, the 1984 Economic Report of the President states in the clearest possible language "The original, indeed, the continuing purpose of the Federal Deposit Insurance System to prevent a financial panic from cascading into a collapse of the banking system by providing deposit insurance so that the failure of one unhealthy institution will not produce panic runs on healthy institutions."

Yet there are those today, those who do know better or ought to know better, those who persist in pursuing the mistaken notion -- because it serves their own purposes -- that the purpose of deposit insurance is to insure accounts and for that matter, their accounts.

These are people who operate financial organizations which are not and do not qualify as depository institutions, indeed, those who are today pushing this erroneous notion the hardest, are those who seek to legitimize the sale of Federal Deposit Insurance through their own unregulated financial entities.

They are the money brokers.

Money brokerage firms are not depository institutions. Nevertheless, there can be no mistaking their intentions.

Michael Blumstein of the New York Times put it succinctly in a recent article. He said, "Like a tidal wave pressing against a sea wall, the securities industry is on the verge of crashing through the banking industry's territory. One of the security industry's main goals is Federal Deposit Insurance."

Mr. Blumstein went on to say, "Since December, 1982, when banks and thrift units began offering federally-insured money market deposit accounts, the securities industry has been nothing short of a fanatic in its effort to break through the banking barrier."

Just last week, another article in the New York Times by staff writer Kenneth Noble reported that Merrill Lynch has begun a grass roots lobbying effort to recruit other brokerages that have retail customers across the country, to join the campaign; to wage a lobbying campaign against the proposed regulations put out for comment on January 16th by the Bank Board and the FDIC.

The article says Merrill Lynch, has sent out letters to a half-million customers and quotes a Merrill Lynch executive as saying his firm has urged Shearson, American Express, Dean Witter Reynolds and Prudential Bache to make appeals to their customers to lobby against the proposed rule.

Again, as Mr. Blumstein pointed out so clearly in his earlier article, one of the securities industry's main goals is Federal Deposit Insurance.

Ladies and gentlemen, Federal Deposit Insurance was the birthright of banks and savings institutions. It was never meant by the Congress to subsidize the operations of the securities industry, through its money-brokering subsidiaries, or the operations of other money-brokering firms.

In my view, the sale of Federal Deposit Insurance by these totally unregulated money-brokering entities perverts -- yes, grossly distorts the purpose Congress meant the FDIC and FSLIC to serve from the beginning.

Congress provided Federal Deposit Insurance to bolster public confidence in the stability and safety of depository institutions themselves, to, as the Economic Report of the President reaffirmed last month, "To prevent a financial panic from cascading into a collapse of the banking system."

The sale of Federal Deposit Insurance by non-depository institutions -- whether it is by the unregulated money-brokering subsidiaries, the Wall Street securities firms or other such entities which likewise seem determined to cash in on the unintended federal subsidy it provides them goes well beyond the scope of purpose that Congress itself intended.

And I must emphasize again, the reason that Congress created the FSLIC and FDIC was and continues to be to bolster public confidence in the stability of the nation's depository institutions so that -- as was stated so well by the Economic Report of the President last month, "The failure of unhealthy institutions will not produce panic runs on healthy institutions."

The purpose was not to insure accounts.

That was the scheme that the Congress chose to accomplish its objective of instilling and maintaining public confidence in the stability of the nation's depository institutions, banks and savings institutions.

One of the money brokers quoted in last week's New York Times article that I have already referred to calls this a consumer issue. Another broker is quoted as saying, "We are financial intermediaries brought on by financial deregulations."

Now, that may well be the case. But in my view, it misses the point and begs the question regarding what liabilities and what deregulation.

In no way did the Congress itself intend that the deregulation of liabilities at depository institutions would serve as a subterfuge for extending the sale of Federal Deposit Insurance beyond the confines of depository institutions themselves to the securities industry and other non-depository institution entities that we know as money brokers.

In that sense, this is not a legitimate consumer issue at all. In fact, that reassuring twists beyond recognition the fundamental purpose that Federal Deposit Insurance has always been intended to serve by the Congress itself.

Congress has never implicitly or explicitly assigned the marketing of Federal Deposit Insurance to non-depository institution entities.

On the other hand, the Congress has -- and has always had the prerogative to do so. But it has never chosen to do so.

Your institutions in the nation's commercial banks are the only financial intermediaries which have ever been assigned the sale of FSLIC and FDIC insurance of accounts by the Congress.

And why?

Because depository institutions play a very special role in our society. It is a role which has been specifically defined by the Congress. It is to serve the depositor and investment needs of the communities in which your institutions do business.

That community service role is literally bathed in statutory fiat and regulatory authority delegated by the Congress to governmental institutions such as the Bank Board, the FSLIC, the FDIC.

This is why your savings institutions are called upon to pay the high cost of regulation. Indeed, it is why the money brokers which are not statutorily-defined or Congressionally-mandated private sector instrumentalities of public policy are neither regulated in any way nor must they pay any of the costs which must be borne by the regulated depository institution itself.

To be chartered as a savings institution or bank and to qualify as a federally-insured institution, you must pay a heavy regulatory burden, including the costs of compliance, supervision, examination, extensive record-keeping, reporting requirements, reserve requirements, deposit insurance premiums and a long list, as you know, of other relatively onerous regulatory mandates.

The cost estimates of compliance with Bank Board reporting requirements suggests that FSLIC-insured institutions spent 1.8 million hours a year in this endeavor alone.

Had depository institutions been paid at the market rate for funds held in reserve by the Federal Reserve last year, they would have earned an additional $4.1 billion.

In addition, the estimated costs of operating the Federal Home Loan Bank System, the Federal Reserve System, the FDIC and the National Credit Union Administration, costs borne fully by depository institutions, totalled more than $1.3 billion last year.

Money brokers, in spite of their self-serving proclamations that they, too, serve some never-specifically-defined public policy purpose, pay none of the regulatory or even deposit insurance cost burdens that your institutions must bear.

It is no wonder, then, that their non-regulated operations benefit substantially. And in this manner, they in fact benefit from a very substantial, unintended government subsidy and it is no wonder they are so ardently seeking to legimitize their ability to ride high and free of charge atop the Federal Deposit Insurance System through the sale of deposit insurance, with none of the costly regulatory overhead of banks and savings institutions.

Yes, they are earning a very handsome profit on that subsidy. And they pay not a penny in the FSLIC or FDIC insurance premiums.

Now, apart from the threat their activities pose to the present and future viability of the Deposit Insurance System itself, which I will get into more deeply later in my remarks, the consequences of permitting this unintended and inequitably-applied government subsidy to continue to be exploited by the money brokers will sooner or later place your institutions at such a deposit-marketing disadvantage, that it will only be a matter of time before the money brokers and not your institutions will be marketing the lion's share of FSLIC and FDIC-insured deposits in this country.

Let me cite a glaring, self-serving example here of just how one of the very largest Wall Street securities firms, whose money-brokering subsidiary deals in billions of dollars of brokerage funds, would solve the problems that we who direct the Deposit Insurance System are seeing.

This particular firm would limit the sale of deposit insurance by money brokers to individual accounts. No more so-called "Institutional funds" could be insured under its proposal -- just individual accounts.

And who might those individuals be?

The same individuals who live in the communities that your institutions are meant to serve -- the retail customer.

For Federal Deposit Insurance purposes, that customer is and ought to be your customer. Did the Congress ever intend that the Wall Street firms money brokerage operations should sell your deposit insurance to that customer? I do not think so.

And if you let this continue, sooner or later -- and probably sooner than you think -- you run the very real risk of relinquishing that individual customer to the money broker.

The fact is, the Wall Street firms, through their money brokerage operations, are carrying on massive advertising campaigns across the length and breadth of the land which say, "Come to us and we will insure your accounts with FDIC and FSLIC Insurance."

The handwriting is on the wall. If you let him sell the deposit insurance, he will take the customer away from you. The special -- yes, unintended government subsidy that he gets for selling Federal Deposit Insurance will assure that this occurs in the future.

For your savings institutions, this can only end in transforming your operations into one-sided, non-deposit-gathering lending and mortgage banking entities.

This has never been the role of the depository institution in America but it will be, by and by, and all too soon, if you as savings institutions' executives fail to come to grips with the stakes involved here, now and down the road.

Is this what you really want? Have you thought about it clearly?

Have you thought about it in terms of how it will impact on the future of your institution and on the future of the savings institutions industry?

If you want the money brokers to become the nation's deposit-gathers -- which they surely will become absent firm, decisive and expenditious remedial action, then it is clear to me that you will end up not being depository institutions at all.

Let no one in this room harbor the slightest doubt that the money brokers are in a position for the reasons I have outlined to take over and to take away from you the federally-insured deposit-gathering function your institutions have had for so many years.

The money brokers have the financial resources to do it and they intend to do it.

Under these circumstances, just how long can you, as an industry, .expect to depend on the continued sympathy of the Congress? The sympathy you now have and have had for a long time in your role as savings institutions.

Just how long do you think you will have the conferred benefits provided by Section 593 of the Insurance Code?

Just how long do you think you will be able to enjoy the benefits now provided to your institutions by membership in the Federal Home Loan Bank System?

Savings institutions, as depository institutions, enjoy these conferred benefits now.

When your institution ends up as simply a mortgage banking operation, because some other kind of entity gathers your deposits for you, I wonder how long you will be able to rely on the sympathy of the Congress to extend such benefits?

These benefits are intended for savings institutions, not for mortgage bankers.

It is time every one of you looked beyond the end of the month, beyond the next financial statement, beyond the next six months. Beyond the next year. To the shape of your future as depository institutions under the scenario I have outlined.

Remember, the new wave of money brokering already growing like wildfire is still only in its infancy. Feeding this infant lion may seem simple and innocent today. As he grows, he becomes more dangerous and chances are very good he will consume you for dinner before very long.

It is time you wake up to the stakes that this issue poses for your future.

If you do not, if you fail to push aside the trees so that you can see the forest beyond, then I fear deeply for the future of the industry.

If you are intent on sacrificing the long-term view for short-term expediency, I must tell you, you will have only yourselves to blame in the end.

What the sky-rocketing growth in third-party, federally-guaranteed and federally-subsidized activities of the money-brokering industry will mean to your Federal Deposit Insurance System, if this activity is not reined in very substantially and very soon, is of the deepest concern to me.

This activity is literally out of control. It is growing by leaps and bounds. If the present rate of brokered funds were to continue out into the future, it would account for fully one-third of all deposits in FSLIC-insured institutions by the end of 1985.

What would it be in 1987? In 1990? None of us knows.

But when you consider that this new wave of third-party, federally-insured money brokering is still only in its infancy, when you consider that money brokering is proliferating very rapidly; when you take into account what New York Times reporter Blumstein called "The fanatic manner in which the securities industry is pursuing Federal Deposit Insurance," then you must also realize that the money brokers have only just begun.

Frankly, I can see no reason whatsoever why this activity will not continue to mushroom out of sight, unless firm, decisive action is taken soon to bring the FDIC and FSLIC-insured activities of the brokers under control.

What does this mean for the Federal Deposit Insurance System? It means that, in addition to underwriting the risk of the deposits that your institutions gather through your own marketing activities, a new magnitude of risk is being layered on top. This new, additional and unintended risk is represented by the sale of deposit insurance by the money brokers.

Is it reasonable to expect that two federal deposit insurance agencies, the FDIC and FSLIC, whose aggregate reserves total slightly more than $20 billion, can possibly be expected to underwrite the total risk of trillions of dollars in deposits that your institutions market? Plus the skyrocketing risk of the rapidly-rising volume of billions and billions and billions of dollars in new, third-party federally-insured broker deposits?

The fact is, the Federal Deposit Insurance System was never meant to underwrite this huge new risk, this double whammy on the FSLIC and FDIC.

The FSLIC and FDIC were never fashioned through the premium structure to bear such a sky-rocketing risk burden. And I would remind you that the money broker never pays a penny in insurance premiums. That cost is borne fully by your institutions alone.

Remember, the total reserves of the FSLIC and FDIC represent but a tiny, almost infinitesimal fraction of the total growth in federally-insured broker deposits which we have every reason to envision in the future.

You must recognize that a substantial part of the little more than $6 billion in reserves held by the FSLIC will be required to pay for the liquidations and the costly assisted mergers that we can foresee or can expect in 1984 alone, most of them as a direct consequence of the brokered money.

The ratio of FSLIC reserves to deposits has deteriorated steadily in recent years to its present point of virtually one percent; given the lightning-fast growth of deposits and the nature of problems the FSLIC is already facing as a result of brokered funds activities, there is no reason at all to expect any strengthtening of this reserves to deposits ratio in the foreseeable future, unless the problem is addressed head-on, and soon.

The last time this reserves to deposits ratio dipped under one percent -- which we are getting very close to -- was in the early sixties. This prompted the Congress itself to establish a costly secondary reserve additional assessment premium on savings institutions. Some of you may remember that.

The sky-rocketing third-party brokered funds activity that we are now seeing leads us to the inescapable conclusion that the current historically low ratio will continue to drop. This, in turn, will surely prompt imposition of additional premium assessments on FSLIC-insured institutions just to bring the ratio back to what it is today, which is, as I say, already well below historic levels.

Frankly, this will be very costly to FSLIC-insured savings institutions, involving billions of dollars in additional assessments.

These higher-premium assessments will have to apply across-the-board to every FSLIC-insured institution, whether or not that institution chooses to take in third-party brokered deposits.

Indeed, that slow grower is going to have to pay the price of higher insurance premium assessments because some institutions are so determined to grow so fast with their heavy ingestion of brokered money.

We cannot operate a deposit insurance fund without sufficient reserves any more than you can operate your institutions with insufficient capital.

Again, the lightning-fast growth of third-party, federally-guaranteed brokered funds activity that we are witnessing can only exascerbate the problems of the FSLIC and indeed, it is doing just that.

The money broker has no incentive to practice any sort of due diligence whatsoever. He sucks money out of local communities, packages it up into bundles of $100,000 or less so it will qualify for Federal Deposit Insurance and makes it instantaneously available to any institution prepared to pay the highest price for the funds.

A telephone call, a quick wire transfer is all that is needed. No need for the money broker to worry. After all, the funds are insured.

Unfortunately, all too often, we are seeing a growing crescendo of cases in which what was only some months ago a healthy institution has become a failing institution.

The ease of access to brokered money not only has brought about incredibly fast deposit growth to such institutions, but this growth just as quickly has transformed itself into risky investments which in turn have produced bad assets.

In fact, the nature of our toughest cases has now changed to investments in bad assets. It is a real change from what we were seeing at the FSLIC during the dark days of 1981 and 1982 when brokered funds really were not the issue.

At that time, earnings spread problems characterized the preponderance of cases that the FSLIC had to deal with. Those problems were expensive. They were difficult. But they were solvable.

Asset quality was, by comparison, very good -- compared to the nature of the problems that we are encountering today.

It is not unusual today for a money broker to place funds at an institution or bank and, at the money of the transaction, to suggest how the funds can be invested very quickly. A particular broker may have already lined up the project to be funded.

The result of all this, quick, easy money. Hurry-up investments. Bad loans and bad assets.

Because of the speed with which these kinds of transactions take place, because we are talking about the transformation of what were healthy institutions into very expensive failures, particularly because of the new bad assets problems, we are encountering very costly difficulties.

These very expensive failures are eating into the FSLIC's reserves. And in this way, further exascerbating that reserves-to-deposits ratio that I talked about earlier.

These brokered funds-related problems are occurring so fast that by the time our examiners discover such problems, it is, in most cases, simply too late. The FSLIC is left holding the bag.

In truth, you do not need too many of these kinds of problems to end up on the FSLIC's doorstep to very seriously endanger the Insurance Fund.

Indeed, from my everyday exposure to the new problems coming on-line, I have reason to say that money broker activities already have begun to jeopardize the Federal Deposit Insurance System.

With what we are now seeing, added to the enormous new risk these brokered funds activities are piling onto the deposit insurance system, it is not only conceivable but in my view, very possible that at some point in the future, massive infusions from the U.S. Treasury and hence, American taxpayers, may well be necessary to shore up the system.

I shudder to think of that possible eventuality and the effect on your credibility as institutions to transact business with the public.

The point is, we are looking at an emerging, serious problem already, the deposit insurance funds. Not to mention the nature of the additional risk that we face, if such brokered funds activities are not reined in very substantially in some manner, very soon.

Because of the multi-dimensional nature of the problems that we are seeing already, and for the future, the Bank Board and the FDIC sought to deal with the overall predicament in mid-January.

Whether you like the proposed rule on brokered funds or not, the fact is, the legal staff's of both the Bank Board and the FDIC have told us over and over, it was and is the only alternative available based on the insurance statutes themselves.

No other alternative has yet been offered to my knowledge which would get at the heart of the problem, based on the insurance statutes themselves.

The reason the proposal was based on the insurance statutes was to assure that if the rule were adopted, it would apply in the same manner to all FSLIC and FDIC-insured institutions.

That is to say, to all banks and savings institutions. They would be treated alike for third-party brokered funds purposes in terms of federal insurance.

This needs to be understood in the light of our desire to make sure that banks and savings institutions would be treated equally.

Now, I know there are those who say they would rather that a proposed rule had been issued which would not have gone so far.

However, parity of treatment for all banks and savings institutions for insured brokered funds purposes, would simply not have been possible under any proposal which was not based on the insurance statutes themselves, according to the legal staffs of both agencies.

Given the compartmentalized nature of banking supervision, and given the divergence of views on brokered funds by banking regulators, the proposal was the only one available to guarantee parity of treatment by all FSLIC and FDIC-insured savings institutions and banks.

Clearly, the comment period which ends March 8th is intended to provide the opportunity for a variety of views to be expressed and we will carefully examine and weigh the comments that we receive before reaching any final decision.

However, irrespective of the final outcome, the fact remains that the stakes for the industry and the Federal Deposit Insurance System are very great.

Unless the vastness -- yes, the enormity of new risk federally-insured brokered funds activities pose for the safety and soundness of the Federal Deposit Insurance System are dealt with decisively and soon, I fear for the future of the nation's depository institutions.

As the operating head of the FSLIC, I simply cannot ignore the clear and very real danger signals ahead.

As I have said, the stakes are very great for a deposit insurance system which was never intended to shoulder the massive new and additional risk burden that we are beginning to confront from a money brokering industry which, like that cuddly infant lion, is growing so fast he may well have the system and your institution for dinner -- all too soon.

Thank you very much. And good afternoon.

EXERTION OF UNDUE PRESSURE TOWARD COMPLIANCE

Senator **Cranston**. Have you sought and received advice that such activities are permissible under the Administrative Procedures Act [APA] or other laws; and would not taint rulemaking with potential unlawful conduct, where you're seemingly putting pressure on people with whom you're regulating and where your rulemaking authority is involved?

Mr. **Gray**. What kind of pressure?

Senator **Cranston**. Well, let me read a Wall Street Journal article referring to your fire and brimstone speech before the U.S. League of Savings Institutions, where you said the following:

> In a speech before the U.S. League of Savings Institutions, he—meaning you—called on the thrift business to join him in his campaign to end the brokered depository system. The threat of increased insurance premiums if that campaign fails added some urgency to Mr. Gray's pitches for support. Mr. Gray said that the increase, which would be the first in 20 years, could boost deposit insurance premiums by as much as one-eighth of 1 percent of deposits. This would produce a total increase of about $780 million a year, nearly one-half of the $1.7 billion in thrift industry profits last year. After Mr. Gray's warning, the U.S. League's legislative council voted to adopt a tougher position than the trade group had taken previously on the brokered funds issue.

Senator **Cranston**. I would feel that forceful advocacy of your position may be proper under the APA. Coercion certainly is not proper.

Why do you think this organization adopted what is called a tougher and different position after your speech? Would they have done so without your fire and brimstone speech and the threat of increased insurance premiums?

Mr. **Gray**. Well, being a former journalist myself, I think that journalists have ways of characterizing speeches in their own way. I would not consider it a fire and brimstone speech by any means, but let me address that question.

In 1962, when the reserves of the fund had deteriorated to less than 1 percent, the Congress imposed the secondary assessment reserve premium structure on the industry. Let me point out that at that very same time, the industry's ratio of real net worth to assets was 7.04 percent.

And since then, the reserves of the FSLIC have steadily deteriorated from 1970 to a point where they are now about 1 percent.

At the same time, the reported net worth-to-assets ratio of the savings and loan industry at the end of 1983 was only 4.03 percent. In terms of operating profits for the industry compared to the 1960's, the situation is even worse because there were really very little operating profits for this industry at the end of 1983.

As a result, we have the fund dipping to a near-historic low of around 1 percent. We have an industry that is extremely fragile. In 1962, the Congress came in and required a very strong industry at that time to provide an additional premium. What I told the U.S. League at the time was simply this: Not what we would do but, rather, that we believe we have the authority to assure that there are sufficient reserves for the FSLIC—that we have the authority to increase premiums by one-eighth of 1 percent.

Now an insurance company cannot operate without sufficient reserves, nor can the FSLIC. This was merely addressing the very real problems that we have in the insurance fund. And I think, Senator, when you take a look at the speech, you will see very clearly that it was presented merely as relevant information in a public forum to the leaders of this particular trade association, rather than being any kind of coercion. That is repugnant to me. I would not do that. It is not my way. And if anyone suggests that this represents coercion, I would be deeply disappointed and I would find that repugnant, as I say.

Senator CRANSTON. Do you think there was a connection between your bringing up the prospect of that large increase in insurance premiums and their change of position?

Mr. GRAY. Well, you'll have to ask the trade association that, but I believe that I have the responsibility to inform the Congress very straightforwardly about the condition of the industry and the condition of the insurance fund. I believe that I have the responsibility to make sure that the leaders of the savings and loan industry in that particular trade association have all the facts, so that when they do make their decision they can take those facts into account.

Senator CRANSTON. You referred to other particular savings and loan trade associations, the California Savings & Loan League. Is it not true that their position in support of what you're seeking here was a reversal of position for them too?

Mr. GRAY. I'm not sure whether they had a position before, to be honest about it.

Senator CRANSTON. I believe they had. Did you not meet with them prior to the time that they took this new position?

Mr. GRAY. I did so, sir, at their request.

Senator CRANSTON. Did you bring up the prospect of the increased insurance premiums in that case?

Mr. GRAY. No, because at the time I didn't have the information, although I believe that I said that because we had a deteriorating reserve level at the FSLIC, that this could not continue to deteriorate, quite clearly. Otherwise, we would not have a fund.

One of the reasons why the reserves of the FSLIC are deteriorating and continue to deteriorate is because of the excessive growth in deposits relative to reserves of the FSLIC. And I can assure you that the growth in brokered funds, starting essentially on December 31, 1981, at $3.25 billion, and skyrocketing in an eightfold increase up to nearly $29 billion at the end of December 1983, has in its own way contributed very substantially to the increase in deposits relative to reserves.

Senator CRANSTON. I thank you very much.

Mr. Conover, do you see any prospect of moving the two gentlemen to your left to a position closer to the more moderate position that you have taken?

Mr. CONOVER. Senator, I wish I did. I agree with them that there is a problem regarding brokered deposits, but I think that there are better solutions. I think both of them know that my staff and I have been willing to sit down and try to work out an alternative solution that would be better than the one that is on the table. So far, no nibbles.

Senator CRANSTON. I have no further questions now.

We will now stand in recess until 1:30 p.m., when this hearing will be resumed. Thank you very much.

[Whereupon, at 11:05 a.m, the hearing was recessed, to be reconvened at 1:30 p.m., this same day.]

AFTERNOON SESSION

The **Chairman**. The Banking Committee will come to order.

We have no witness, but that does not deter me from starting the committee on time. I'm sometimes very sorry that I got myself trapped into that 3 years ago saying that it would never start late. It has not, but sometimes that is a burden to keep up with the trap I set for myself.

Nevertheless, once again we have started on time and in Mr. Shad's defense he was scheduled to appear this morning, as was Mr. Ginsburg, and due to the meeting of the Republican caucus with the President we had to defer until this afternoon, so he undoubtedly has a justifiable excuse since it was we that changed his schedule.

Nevertheless, having opened the meeting on time, we will now have a short recess until the witness appears.

[Recess.]

The **Chairman**. Mr. Chairman, I've already apologized for you and the fact that we changed your schedule. If this had been your original schedule you would have been in trouble, but when we change the schedule we accept the blame.

Mr. **Shad**. My apologies. I'm very sorry.

The **Chairman**. It's not necessary. The apologies come from the President. He was the one that disrupted my schedule and he disrupted yours. So we will both accept the President's apology.

Please go ahead with your testimony.

STATEMENT OF JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. **Shad**. It is requested that the Commission's formal testimony be included in the record.

The **Chairman**. It will be included in its entirety.

Mr. **Shad**. Chairman Garn and members of the committee, the Securities and Exchange Commission appreciates this opportunity to testify in support of S. 2181 and S. 2134. With minor exceptions, the Commission strongly endorses those provisions of these two bills which relate to the SEC's areas of responsibility. Enactment of this legislation would be a major step toward fair and equitable, functional regulation of financial services.

SEC ADVOCATES REGULATION BY FUNCTIONAL ACTIVITY

The SEC has long advocated regulation by functional activities, rather than by outmoded industry classifications. The need for this legislation continues to escalate. In less than 2 years, over 1,000 depository institutions have entered the securities industry, and at least that many are believed to be considering doing so.

The number of securities firms and their resources are a fraction of the depository institutions, but based on limited data, securities firms have acquired over 15 depositories and trust companies, not to mention insurance companies, and a variety of other financial service concerns—and, of course, this is only the beginning.

In response to the rapidly changing marketplace and disparate regulations, Federal and State regulatory agencies have been pursuing a variety of ad hoc and often conflicting approaches.

The Commission would offer six suggestions concerning S. 2181 and S. 2134.

First, the Commission would recommend that depositories be required to conduct their existing public brokerage activities in separate securities affiliates, subject to the same rules and regulations as all others who engage in such activities, regardless of whether or not they engage in the new securities activities that would be permitted by this legislation.

Second, while the Commission has endorsed legislation to facilitate the financing of mortgage-backed securities, it does not support the proposal to permit depositories to underwrite public offerings and make markets in such securities. They are much riskier securities than State or Federal obligations. The other provisions of the proposed legislation would significantly expand depositories' securities and other activities. It is, therefore, recommended that this additional activity not be authorized at this time.

Third, the SEC believes the approach proposed for permitting bank trust departments to purchase securities or assets from their own securities affiliates is too permissive. Glass-Steagall was intended to address past abuses in this area. The bills would permit such transactions, if provided for in trust agreements. However, boilerplate provisions in trust agreements could facilitate overreaching by banks of trust beneficiaries. Registered investment advisors are required to obtain consents for each principal transaction.

Fourth, the Commission supports the proposal to exempt from the registration requirements of the 1933 act, the exchange of equity securities issued in the creation by a depository of a holding company parent. Under this proposal, the shareholders must maintain the same proportional share interest in the holding company. However, the Commission would propose that the legislation be amplified to provide that the holding company's charter and bylaws may not materially alter the shareholders' voting or other rights and interests. For example, the exemption should not be used to avoid the necessity to obtain shareholders' approval of defensive charter amendments, such as the requirement of a supermajority to approve mergers. The Commission also recommends that all corporations, not just depositories, be afforded a similar exemption subject to the amendments suggested.

Fifth, the Commission recommends that holding companies that serve as advisers to affiliated investment companies be required to register under the Investment Advisers Act. The legislation requires such registration by advisory affiliates but not by holding companies that act as advisers.

Finally, the Commission supports the limited purpose consumer bank provisions of S. 2181. If depositories are permitted to enter facets of the securities business, securities firms should be permitted to enter facets of the banking business under the clear definitions of the limited purpose consumer bank provisions.

Thank you. I will be glad to respond to any questions.

[The complete statement follows:]

STATEMENT OF JOHN S.R. SHAD
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS

March 21, 1984

Chairman Garn and Members of the Committee:

The Securities and Exchange Commission appreciates this opportunity to testify on the proposals pending before Congress to reform regulation of the financial service industries. As the federal agency responsible for the protection of investors and the maintenance of fair and orderly securities markets, the Commission has a fundamental interest in the structure of financial regulation.

Summary

With minor exceptions, the Commission strongly endorses those provisions of S. 2181 and S. 2134 that relate to the SEC's areas of responsibility. The Commission has some suggestions for improvements in those provisions, discussed below.

Consideration of S. 2181 and S. 2134 is an important step in a comprehensive review of regulation of the financial service industries. These bills address many of the complex issues facing Congress and the federal and state regulatory agencies as the distinctions between the banking, securities, insurance, retail and other industries continue to erode.

Importantly, both bills incorporate the provisions of the Treasury proposal, S. 1609, which would permit bank holding company securities affiliates to underwrite municipal revenue bonds and sponsor and distribute mutual funds and would require banks to transfer their securities activities into such affiliates if the affiliates engage in these new activities. The Commission testified in support of this proposal in February 1982 and June 1983 because it would provide functional regulation and would eliminate inequalities that arise from applying different legal regimes to concerns performing identical economic functions.

Pending congressional action, the SEC has found it necessary to release for public comment a proposed rule which would in effect require banks that solicit public brokerage business or engage in in-house brokerage and investment advisory activities to transfer these activities to separate affiliates, subject to the same rules and regulations as all others who engage in such activities.

The need for a legislative program that addresses these issues continues to escalate. Banks, savings and loans, and insurance companies are entering the securities industry, and securities firms are entering the banking industry at an accelerated pace. In response, federal and state regulatory agencies have followed ad hoc, frequently inconsistent approaches that do not reflect a national policy on the regulation or operation of these industries.

It is urgent, therefore, that Congress consider the proper relationship between the securities, banking, insurance, and other financial service industries. Four general reform objectives are recommended:

- the safety and soundness of the banking system;
- regulation by functional activities, rather than by outmoded industry classifications, so that competitive activities will be subject to the same rules, regulations and tax treatment, administered by the same agencies;
- consolidation of overlapping and duplicative regulatory activities; and
- elimination of excessive and conflicting regulation within and between regulatory agencies.

As to the last two objectives, as indicated below, the Bush Task Group will be making recommendations to Congress to consolidate certain overlapping and duplicative and eliminate certain excessive and conflicting regulations.

This testimony discusses S. 2181 and S. 2134 and makes specific recommendations on the provisions contained in these bills. To a large degree, the two bills concern matters of banking law. The Commission will limit its comments to areas concerning the effective administration of the securities laws.

Bank Securities Activities

Both S. 2181 and S. 2134 contain provisions that require banks to conduct securities activities within non-bank holding company affiliates, if they engage in certain newly-permitted activities. This approach addresses multiple regulatory disparities under current law.

The bills would permit either the holding company parent or a non-bank subsidiary to underwrite and deal in municipal revenue bonds and to sponsor, advise, and distribute mutual funds. If a securities affiliate or the parent holding company engages in these expanded securities activities, banks and their subsidiaries would be required, after one year, to transfer their other securities activities, including brokerage services, into the securities affiliate and would be prohibited, with certain exceptions, from engaging in securities activities directly. Under S. 2181, the same principles would apply to S&Ls and their holding companies.

The Commission reaffirms its past support for this approach, which has several advantages.

First, it would afford investors that use depository institutions for their securities transactions, the same protections as those who deal through broker-dealers. The Exchange Act and rules thereunder, provide comprehensive regulation of persons who sell securities. They are required to pass qualification examinations and are subject to supervision by qualified individuals. The Exchange Act also provides for regulation by self-regulatory organizations, under rules that address abusive and unethical sales practices.

In addition, the Commission and the self-regulatory organizations have promulgated rules defining fraudulent practices and have accumulated expertise in examining broker-dealers for violations of the securities laws.

Second, under both bills bank-sponsored mutual funds would be subject to the same rules and regulations under the Investment Company Act as all other investment companies, and the securities affiliates that may advise such funds would be subject to the Investment Advisers Act. This is appropriate because these statutes provide a comprehensive scheme of investor protections. The statutory provisions of the Investment Company Act regulate, among other things: the composition and accountability of management to shareholders; the approval of investment advisory contracts; changes in fundamental investment policies; transactions between investment companies and affiliated persons; and investment companies' capital structures. The Investment Advisers Act has antifraud provisions, disclosure and recordkeeping requirements. Securities affiliates that distribute investment company shares would also be subject to the Securities Exchange Act broker-dealers provisions.

Third, if banks and other financial institutions are permitted to sell securities and sponsor investment companies, they should be subject to the same regulatory structure as all others with whom they compete. The depository institution brokerage field last year. Many banks publicly solicit such business. They receive a portion of the commissions paid by the customers to the entity that executes the securities transactions. These activities and transaction-related fees have substantially changed the nature of the brokerage service offered by banks. Rather than merely providing accommodation services to existing customers as contemplated in 1934, the services provided are functionally indistinguishable from those offered by registered broker-dealers.

The Commission has proposed for public comment Rule 3b-9 which would require banks to register as broker-dealers if they publicly solicit brokerage business, receive transaction-related compensation for providing brokerage services for trust, managing agency, or other accounts to which the bank provides advice, or deal in or underwrite (on a firm or best efforts basis) securities, other than exempt securities. It is contemplated that if the rule is adopted, banks will set up separate entities to carry out such brokerage functions.

The Commission suggests that this committee consider codifying the foregoing proposed rule, or amending the proposed legislation to require that bank securities activities of the type described in proposed Rule 3b-9 be transferred to affiliates.

Employee Benefit Funds

The transfer of bank-sponsored collective trusts for employee benefit plans to securities affiliates is recommended, because these funds compete with regulated investment companies. The rationale for the exempting these funds from the registration provisions of the securities laws was largely that the banks that provide these services are not making public offerings. However, banks now solicit such business from employee benefit managers directly and in public advertisements, in competition with investment companies and advisers. In addition to violations of the limitations on the form, substance, and claims in such ads applicable to others that provide such services, there have also been deficiencies in the disclosures provided to employee benefit plan managers.

There are presently significant disparities in the regulatory schemes under which bank-sponsored collective investment vehicles and securities firm-sponsored investment companies operate. Some collective investment products offered by banks are subject to the federal securities laws; others are not. Those regulated exclusively under the banking laws are not subject to as specific standards as those subject to the securities laws. This disparity of regulation can be traced to the differing orientations of bank and securities regulation. Banking regulation emphasizes the stability of banking institutions and the protection of depositors' funds. Securities regulation focuses on investor protection through full disclosure and other regulations. Employee benefit managers and participants are entitled to such protection.

Investment Advisers

Bank holding companies currently are excluded from the definition of investment adviser under the Investment Advisers Act of 1940, and are thus not subject to the safeguards in the Act and the rules thereunder. Under the proposed legislation, bank affiliates would be allowed to sponsor and underwrite mutual funds; however, under S. 2181 if the holding company parent served as the adviser, it would not have to register or be regulated under the Advisers Act. In contrast, S. 2134 amends the Investment Advisers Act to require registration.

In 1970, Congress amended the Advisers Act to require investment company advisers to register. But, under S. 2181, bank holding company advisers to affiliated mutual funds would not be subject to the Advisers Act restrictions on performance-based fees and other regulations. It would be anomalous if all financial institutions offering investment advice to registered investment companies were not subject to the same regulatory requirements and fiduciary responsibilities, under uniform enforcement.

It is proposed that the S. 2181 be amended to require that investment advisers to bank-sponsored mutual funds be required to register under the Advisers Act. Such advisory activities should be conducted by registered affiliates. A bank holding company could register directly as an adviser; however, this would subject the bank holding company to regulation under the Advisers Act. The same services could be provided by an affiliate.

Mortgage-Backed Securities

Both S. 2181 and S. 2134 would permit securities affiliates of banks to underwrite and deal in mortgage-backed securities. S. 2181 would permit securities affiliates of S&Ls to do so. There are two other bills (S. 2040, H.R. 4557) pending before Congress that also would allow depository institutions to do so.

Presumably, the intent of Section 104 of S. 2181 and Section 5 of S. 2134 is to authorize depositorv institutions to underwrite and deal in mortgage-backed securities that are not guaranteed by a federal agency, since banks may now do so with respect to such guaranteed securities. In commenting on a predecessor of S. 2040, the Commission recommended that the question of whether banks or bank affiliates should be permitted to engage in such activities should be considered in conjunction with S. 1609, the Treasury proposal.

The Commission supports the general principle of facilitating mortgage financing by encouraging the marketing of mortgage-backed securities. However, the Commission cannot support the provisions on this subject in S. 2181 and S. 2134. These bills would permit the activity in broad terms under circumstances that would make mortgage-backed securities essentially indistinguishable from other securities, except for the use of the proceeds.

These provisions, if adopted, would further erode the Glass-Steagall Act by authorizing depository institutions' securities affiliates to underwrite and deal in another category of securities that are far from risk-free. The apparent theory is that privately-issued mortgage-backed securities are essentially similar to government securities in which banks now deal. But government guaranteed securities are relatively risk-free, whereas, mortgage-backed securities, issued by private parties, involve much greater risks. Even though mortgage-backed securities are backed by interests in real estate, their soundness depends on the responsibility of the private issuer to thoroughly assess the mortgages, and their security and collateralization provisions. Therefore, mortgage-backed securities that are not guaranteed in whole or in part by a government agency raise the same concerns that led to the enactment of Glass-Steagall -- banks and bank affiliates underwriting of privately-issued, potentially-risky securities, creating potential conflicts of interest, and jeopardizing the safety and soundness of the banks. In short, if commercial and investment banking are to remain separate activities, there is no principled reason to permit depository institutions to underwrite mortgage-backed securities.

Underwriting Corporate Securities

S. 2134 would extend the Glass-Steagall Act restriction on affiliations between banks and securities firms to federally-insured, non-member state banks. Section 20 of the Glass-Steagall Act currently provides that no member bank shall be affiliated with an organization that is engaged principally in the issue, flotation, underwriting, public sale, or distribution of securities. The prohibition in Section 20 has been interpreted by the FDIC to apply only to member banks and not to non-member banks, allowing them to affiliate with securities firms. Based on this interpretation, the FDIC proposed a rule that would permit "bona fide" subsidiaries of federally-insured non-member banks to engage in underwriting broad categories of securities, subject to certain conditions. The FDIC indicated its rule would be necessary to place appropriate limitations on securities activities of subsidiaries of federally-insured state-chartered banks. Adoption of the proposal in S. 2134 would apply the prohibitions of Glass-Steagall to federally-insured state-chartered banks, making the FDIC's rule proposal moot.

The Commission supports this proposal. There is no reason why affiliates of 8,800 federally-insured, non-member banks should be able to engage activities not allowed to 5,600 member banks. To permit federally-insured banks to engage in certain securities activities merely because they are state-chartered, and not members of the Federal Reserve system, would increases regulatory disparities. Therefore, this anomaly should be foreclosed.

Conflicts of Interest

S. 2181 and S. 2134 would amend the Federal Reserve Act by adding Section 23B to regulate conflicts of interest between a bank and its securities affiliate. The new section would provide that a member bank and its subsidiaries may engage in certain transactions with an affiliate, but only if the terms and conditions of the transactions, including the credit conditions, are substantially the same, or at least as favorable to the bank as those prevailing for transactions with non-affiliated companies.

The amendment would also prohibit a bank and its affiliates from advertising or entering into an agreement that suggests that the bank is responsible for the affiliate's operations (although the bank and the affiliate could use a common name or corporate symbol). In addition, a bank would be prohibited from purchasing as a fiduciary any securities or other assets from the affiliate unless such practices were authorized by the trust instrument, by court order, or by the jurisdiction where the trust is administered.

The Federal Reserve Board would be given authority to exempt transactions or relationships from the requirements of this section, if the Board finds such exemptions to be in the public interest. S. 2181 would apply the same provisions to S&Ls.

The Commission agrees with the need to address possible conflicts of interest in relationships among depository institutions and their non-depository affiliates. However, it would be too permissive to allow the purchase of securities or assets from the affiliate by the depository as fiduciary simply because the trust agreement permits such transactions. Boilerplate language in trust agreements would facilitate possible overreaching by banks of trust beneficiaries.

Corporate Reorganizations

S. 2181 and S. 2134 would amend the Securities Act of 1933 to exempt from the registration requirements the offer and sale of stock of a holding company to the shareholders of a bank in exchange for their shares in the bank, as long as they receive substantially the same proportional share interest in the holding company. S. 2181 would apply this exemption to S&L holding company formations.

The Commission supports these proposals, provided that the holding company's charter or by-laws do not materially alter the shareholders' voting and other rights and interests;

for example, supplant simple majority with super-majority (i.e., 80%) requirements to approve mergers. Given this amendment, the Commission sees no reason to limit the exemption to depository institution conversions. Accordingly, the Commission recommends that the committee consider expanding the amended proposal to exempt from the 1933 Act registration requirements, all exchanges of securities in connection with corporate reorganizations that do not involve cash payments by security holders or changes in the rights of investors, or restrict transfers of securities or involve other modifications of corporate charters or by-laws that would affect changes in control. The Commission staff would be pleased to consult with the committee staff on appropriate language to achieve the foregoing purposes.

Amendments to the Investment Company and Investment Advisers Acts of 1940

S. 2181 and S. 2134 would amend the Investment Company Act of 1940 to clarify the Commission's authority over custodianship or trustee arrangements between an investment company and its affiliated bank. Specifically, the proposals would amend the Act to permit an investment company affiliated with a bank holding company securities affiliate (or in the case of S. 2181, with an S&L holding company securities affiliate), with the prior approval of the Commission, to

(1) place its securities or similar investments in the custody of a bank affiliated with such securities affiliate;

(2) designate any such bank as trustee or custodian of the investment company; and

(3) deposit designated proceeds with any such bank under this section.

The Commission would have discretion to determine whether and, if so, under what circumstances and conditions, a bank and its affiliated investment company might enter into these arrangements.

Presently, the Investment Company Act provides that an investment company can place its securities in the custody of a bank that has a specified minimum level of assets and reports its condition at least annually. Because investment company assets are highly liquid, the Commission consistently has required that these assets be adequately segregated and not readily accessible to investment company insiders. This is particularly important in situations where an affiliate of the investment company, or an affiliate of an affiliate, is entrusted with the care of its assets. We support the provisions S. 2181 and S. 2134 because they would give the Commission specific authority to ensure that the interests of investors are protected when mutual funds and other investment companies use affilated banks as custodians.

S. 2134 also would amend the Investment Advisers Act of 1940 to make clear that a bank holding company engaged in the securities advisory activities authorized by the bill would be an investment adviser for purposes of the Investment Advisers

Act. This is necessary because the definition of investment adviser in the Act specifically excludes bank holding companies. The Commission supports the proposal. Holding companies that provide investment advice to investment companies should be subject to the same regulation as securities firms offering the same service.

Non-Bank and Consumer Banks

S. 2181 and S. 2134 adopt different approaches to the issue of the ownership of limited-purpose banks by non-banking institutions. S. 2181 would allow holding companies or other institutions to own "consumer banks" without being subject to the Bank Holding Company Act. S. 2134 adopts a narrower approach to the issue of non-bank banks. That proposal adopts the definition of the term "bank" proposed by the Treasury Department in S. 1609. However, S. 2134 specifically excludes certain trust companies from the definition of bank for purposes of the Bank Holding Company Act. This would appear to permit securities firms and other institutions to acquire or organize trust companies without being subject to the Bank Holding Company Act. Although the powers of trust companies generally are not as broad as consumer banks, it appears that trust companies would have the authority to manage employee benefit fund assets.

The Commission supports the proposal in S. 2181 to allow limited-purpose consumer banks. The amendment is consistent with the promotion of fair competition. It reasonably limits the activities of consumer banks to non-commercial banking while enabling securities firms to engage in limited banking activities. Bank entry into the securities business through subsidiaries or affiliates has continued at an accelerated pace and would be expanded under S. 2181 and S. 2134. Securities firms and other entities should not be limited in their ability to enter facets of the banking business, if banks are not similarly limited in their ability to enter the securities or other non-banking businesses. Authorization of consumer banks would reduce one of the barriers to competition for securities firms and other financial entities that wish to compete with banks.

Limitation on Affiliations

S. 2181 would amend the Bank Holding Company Act and the Savings and Loan Association Holding Company Act to prohibit large bank or S&L holding companies that own depository institutions with domestic deposits exceeding 0.3 percent of total domestic deposits from investing more than 25 percent of the holding company's total capital in any one of the new permissible activities (insurance, securities, and real estate). A similar standard would limit the acquisition of large banks or S&Ls by large financial organizations. The bill would not, however, prohibit internal growth or development of new activities by existing holding company subsidiaries. Senator

Garn has stated that this provision would apply to the largest 25 holding companies.

The Commission does not oppose this proposal. It attempts to addresses the concerns of some about undue concentrations of financial power. It should be noted that Citicorp has an indicated net asset value of $6.6 billion for December 31, 1984. Under the proposed legislation, Citicorp would be able to invest up to $1.6 billion in one of the new permissible activities which would be equal to over six times the total market value of The Dreyfus Corporation, a mutual fund adviser. BankAmerica, the holding company of Bank of America, would be able to invest up to $1.3 billion. These figures represent a multiple of the current market value of all but one of the publicly-held securities firms.

Regulation of Non-Bank Affiliates of Holding Companies

S. 2134 would amend the Bank Holding Company Act to provide that non-banking subsidiaries of bank holding companies may generally satisfy the reporting requirements of that Act by submitting the same information submitted to the Commission. The Commission supports this proposal. It would further the objective of reducing duplicative, overlapping, and excessive regulation.

Preemption of State Law

S. 2181 would reverse actions similar to that taken by South Dakota to allow banks located in South Dakota to sell insurance outside South Dakota on a basis different from that authorized for such banks within South Dakota. The bill provides that no state may authorize banks which it charters to engage in insurance activities outside such state on a different basis than that authorized within the state. S. 2134 would prevent bank holding companies from engaging in nationwide insurance activities through a bank chartered in a state with permissive laws, such as South Dakota.

The Commission has no jurisdiction over the activities that these sections are intended to address. Nonetheless, we believe the proposal would rectify a regulatory disparity in a reasonable manner, and would raise the question as to whether the principle should be applied to other activities in addition to insurance.

Moratorium

Recently there have been renewed suggestions for a statutory moratorium on new developments in the financial service industies. As a general matter, the Commission believes that congressional action to address the growing disparities between the system of financial regulation and developments in the industry is essential. Congress should carefully consider whether a brief moratorium would be contrary to that goal. Legislation which simply freezes the status quo would be counter-productive.

Bush Task Group

With respect to the third and fourth objectives suggested on page 3 -- consolidation of overlapping and duplicative and elimination of excessive and conflicting regulations -- the Bush Task Group has recently propounded specific recommendations for legislation to improve the current system of federal regulation of financial services. The recommendations include consolidating all securities disclosure regulations applicable to banks and thrifts within the SEC, and making the registration requirements of the Securities Act applicable to public securities offerings of banks and thrifts (but not deposit instruments). These changes would result in more uniform regulation and financial disclosures to investors and securities analysts, at lower cost. They would also facilitate the comparative evaluation of investment opportunities. Delays in conforming regulations governing depository institution filings with those applicable to all other publicly-owned corporations would be eliminated, and duplication of agency staff requirements in establishing, interpreting, processing and enforcing securities disclosure requirements would be reduced. The Commission would become the repository for filings of all publicly-held banks, savings and loan associations, and their holding companies, as it is for all other publicly-owned companies.

Other recommendations include: substantial reorganization of regulation of commercial banks by creating a central federal banking agency for regulation of national banks; transfer of regulation of bank holding company activities for national banks to the new banking agency; and reform of the federal deposit insurance system.

* * *

The Commission would be pleased to provide the committee any additional assistance it desires on the foregoing matters.

The CHAIRMAN. Thank you, Mr. Chairman.

You support the concept of a consumer bank, as you just stated, and referred to additional competition and more consumer choices as the benefits of this.

This morning with the other regulators we discussed at quite great length what is a bank and what the definition of a bank should be. Chairman Isaac recommended that any institution that is FDIC insured and calls itself a bank is a bank, and his premise was that people have come to trust banks because of insurance over the years and it is misleading to them when institutions call themselves a bank and are not. They expect the security that goes with that. That is why he felt that if they had to call themselves a bank, then they would have to be regulated as a bank and the insurance would have to go with it.

Mr. Conover, the Comptroller, agrees with the definition in S. 2181.

So the point is, there are still varying viewpoints on what a bank is and how we should define it. So the question is simply, do you have a definition of a bank? What do you think a bank is or should be?

Mr. SHAD. Mr. Chairman, I think that Mr. Isaac's definition is a very interesting one. I've been guided in terms of the SEC's areas of concern by the Bank Holding Company Act definition, which is that if it takes demand deposits and engages in commercial lending it's a bank. But I appreciate that if the world thinks it's a bank and if it provides Federal insurance, then perhaps it should be treated as a bank.

The CHAIRMAN. We also had a great deal of discussion about brokered deposits and how we handle that. There are discussions about putting a total limit, 5 percent or varying amounts and there was a difference of opinion on what that total cap amount should be of what a bank could accept in the way of brokered deposits. Once again, we have disagreement on how it should be handled.

In my own opinion, and I believe in the opinion of those who testified this morning, there is no disagreement that it is a problem that needs to be addressed, whatever the solution is.

WHAT IS THE MAGNITUDE OF THE PROBLEM OF BROKERED DEPOSITS?

Would you express your opinions on, first of all, the magnitude of the problem of brokered deposits, possible threat to the insurance programs, and if you have any recommendations of how it should be handled? The Comptroller thought that the definition under the proposed regulation by the FDIC and the Federal Home Loan Bank Board was overkill and went too far. So once again, we have varying opinions. Everybody agreed that it's a problem. The discussion and controversy is on how we solve it.

Mr. SHAD. I testified in the House on this and agree with Todd Conover's view that it is overkill. The rule as proposed will not only eliminate the adverse aspects of brokered deposits but also the very desirable aspects. The people who would suffer, for instance, would be small depositors who are not capable of shopping for a rate usually beyond their own locale.

Merrill Lynch has testified, of course, that their average brokered deposit is $14,000. But, I think the principal concern is over the very large deposits, $1 million to be placed and broken up into 10 pieces and placed at the highest possible rate because it's insured, and oftentimes with depositories on the brink of collapse, and therefore aggravating or increasing the exposures of the insurance funds.

But also I think the brokered activities serve the national interest by moving funds around to those areas of the greatest need and demand within the United States. So the SEC would propose limiting and perhaps even prohibiting access to brokered deposits by imprudent depositories, those that rank at the bottom of the list of the FDIC and the Federal Home Loan Bank Board. Their investigators are constantly classifying banks, and it seems to me that this would be an area to prohibit banks in the bottom categories from accepting brokered deposits and perhaps even limiting all depositories to some percentage of brokered deposits.

But we would favor and idea originally advanced by Bill Isaac in another context. He doesn't favor it now in this particular area because he wants basically to put a stop to brokered deposits, but he was the author, as far as I'm aware, of the idea of trying to increase the disciplines of the marketplace to facilitate funds flowing into strong instead of weak depositories through risk-related insurance premiums and a less than full recovery on deposits of over $100,000 in federally assisted mergers of weak or troubled depositories. And we would support that approach.

The other thing is the activity breaks down into multiple areas. I believe out of the $1.8 trillion of insured deposits in the United States, only about $80 billion have been brokered, and of that, individuals who I think are served by this only amount to $16 billion; and the insured institutional brokered deposits only amount to $6 billion.

So the bulk of insured institutional deposits are not brokered and there will be lists published in the press and elsewhere of where to get the higher rates, so the sophisticated larger depositors will be able to continue to direct their funds perhaps into troubled institutions, despite the fact that money brokers have been eliminated.

There's another aspect of it that has been raised, if you want me to respond to it, by Senator Hawkins' proposal that the SEC regulate money brokers.

The CHAIRMAN. Well, I'd be interested in your opinions on that. Let's finish this one first.

Chairman Gray and Chairman Isaac are both very, very concerned about what they describe as the very rapid growth of brokered deposits and that this is at such a pace that it endangers the insurance funds, and they can't be sure at all about what their future liability would be in those funds. That's where they're coming from in their proposed regulation.

Also, Chairman Isaac said that he didn't believe insurance was designed to be sold by anyone other than an insured institution.

So there are some suggestions that maybe we should reduce the amount of insurance coverage on brokered deposits.

Do you have any comments on taking that approach?

Mr. SHAD. Well, I don't agree with him when he uses the expression that it's being sold by brokers. I don't think it's being sold by brokers. I think the law is intended to provide protection to depositors, and brokers are facilitating it. They're just the agents. I think this proposal would kill the messenger but not solve the problem.

I certainly share, as I think all of us do, the very, very serious concerns of the FDIC and the Federal Home Loan Bank Board over the exposure of the insurance funds. I know that others have come to quite different conclusions in terms of the escalating rate, but Ed Gray's chart goes up exponentially. Others would argue that there has been an initial bulge here, but it's not going to grow at anything like the rate he projects.

But there's no question that the FDIC and the FSLIC are confronted with huge exposure, and it's going to grow, and it's a serious concern. Brokered deposits are a tiny piece of that problem. There's $1.8 trillion insured; brokered deposits are less than about $80 billion, and of that, most of it's uninsured; so only $22 billion of it is actually insured. So I think the tendency is to use a meat ax instead of a scalpel, frankly, on the problem.

The CHAIRMAN. What you say is true as far as the totals, but isn't it true that brokered deposits have been concentrating in a much smaller number of institutions? Look at the exposure that Penn Square had and how rapidly they became a big bank, partially due to brokered deposits. Chairman Isaac testified this morning that in some cases more than 76 percent were brokered deposits and directly contributed to the failure of some of these banks.

So your $80 billion versus $1.3 trillion is true, but those brokered deposits have gone to very narrow interests and were therefore much more concentrated.

EFFORTS SHOULD BE DIRECTED AT IMPRUDENT AND WEAK DEPOSITORIES

Mr. SHAD. Well, I agree, and that's precisely where I think they ought to direct their efforts, at the imprudent and weak depositories. What will happen then is that there will continue to be brokered deposits but they won't be putting the money into the weak ones. They will be putting them into the other ones that pay above average rates and can be justified economically.

I don't think that the brokered deposits have caused a collapse. In some cases, when a bank has attracted deposits aggressively and was not able to prudently invest their funds, they may have contributed to it, but I think the most egregious cases are those where the depository is failing and they're just bringing in the money rapidly to meet the next demand at the window, and that's just exacerbating the problem, not creating it. They already had the problem.

The CHAIRMAN. Well, I understand, but that's where the problem comes for the insurance funds and the depositors.

Mr. SHAD. That's correct. Therefore, I think you should put the burden on them to properly police the industry and impose prohibitions on brokered deposits to those depositories that are in financial difficulty or approaching it.

The CHAIRMAN. All those on the troubled list or how do you define it?

Mr. SHAD. I believe they have five categories, although this is not an area of the SEC's activities, I would certainly take a very hard look at the level of deposits of the two bottom categories as they rank them.

The CHAIRMAN. Have you got any percentage figure you would recommend as far as the total cap? They talked about 5 percent today. Todd Conover also talked about double their capital—3 to 6 percent, or in case they had 6 it would be 12.

Mr. SHAD. Well, I've thought about that. This is not in the SEC's area, but I understand the idea of relating it to their net capital so that those that have the best capital have the opportunity to take advantage of brokered deposits. Double the net worth is an interesting approach, but we haven't done any analytical work on it.

One additional recommendation that I didn't mention that we would propose, in addition to haircuts on large deposits in the event of a supervised merger and the risk-related premium reserves, is proper disclosure to the depositors—not a full-blown SEC type of disclosure, but some key information, so that depositors can assess the risk of the depositories in which they are putting their money. You know, Ed Gray criticizes the brokers because they don't do their homework on some of the troubled depositories, although Merrill Lynch says they do and so do others. There are only seven firms, incidentally, that handle virtually all of the individual brokered deposits and they are all registered with the SEC.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Mr. Chairman, I'm on a tough timeframe. I'm going to forego my questioning and hear the next witness before I have to leave. Is he here?

The CHAIRMAN. He's here, but we're not through with Chairman Shad.

Senator HECHT. I'm sorry. Well, go on. I'd rather forego my questions because I have to leave in just a few minutes.

The CHAIRMAN. We're not going to let him off that easily.

Chairman Gray stated that thrifts should not be allowed to affiliate with securities underwriters or dealers because of the conflicts that might arise.

Do you agree and do you believe there are any potential problems in having securities firms owning a thrift or a consumer bank?

Mr. SHAD. No. I think there are potential problems, but I think the bill as proposed deals with those problems.

The CHAIRMAN. How do you square your support of open ownership of consumer banks with your opposition permitting bank holding companies to underwrite mortgage-backed securities?

Mr. SHAD. I think that we are in an era of rapid transition and there are huge present problems on the table. The SEC would recommend that the Congress deal with the immediate problems of functional regulation, of protecting investors, and the safety and soundness of the banking system through the broad approach of separate securities affiliates and giving the banks the additional latitude of underwriting revenue bonds and sponsoring or underwriting and distributing mutual funds before we start talking about a lot of others; especially since the mortgage-backed securities are essentially going to be uninsured, not federally guaranteed mortgages. The latter will continue to be sold through GNMA, FNMA, and the others. But the bills before this committee would cover second mortgages and mobile homes, and so it really is a high-risk area of the underwriting market, and it seems premature to me, just as is the case with the possibility of corporate securities. I think that there are top quality corporates, but I still think it's very premature to consider that area before we've even got this new layer of organization and lack of full information under control.

The CHAIRMAN. You suggest in your testimony that banks should be required to put their discount brokerage operations in a separate subsidiary, even if they don't go into the new powers in S. 2181. Banks have been in the discount brokerage services for a long time now, at least a reasonable amount of a long period of time, and they haven't had any particular problems.

Unless they get into new services which everybody has agreed would be in a separate subsidiary, why would you want to require to put the discount brokerage which they have been doing for some time in a separate subsidiary?

BANKS EXPANSION IN BROKERAGE ACTIVITIES

Mr. SHAD. Well, initially, they were exempted from the 1934 act's definitions of broker and dealer because, while they did provide such services, it was merely an accommodation to their trust accounts and a limited number of bank customers. Today, they're running full-page advertisements. They are aggressively competing and they're doing it under terms and conditions that are not permitted to the rest of the industry. You see these ads that say, "We're delighted to announce that we can now enter"—over the name of a bank, "We are delighted to announce that we can now provide the public with discount brokerage service. Call the following 800 number." And the 800 number is a registered broker-dealer, but they get a piece of the commissions that are generated from the calls that come in over that number.

They are also planning to provide in-house both advise and brokerage activities, which would be on different terms and conditions and subject to less protection for the clients than all others who engage in the activity.

So when it was a nominal activity, no one was complaining or expressing concerns. But now, it's a very, very broad-gaged activity and the protections of the Federal law are being eroded for investors, depositors, and the banking system.

The CHAIRMAN. Assuming I agreed with your arguments, but if a bank didn't engage in new activities, wouldn't a subsidiary of the bank be sufficient to handle what you're suggesting rather than having to create a bank holding company subsidiary?

Mr. SHAD. Oh, I'm sorry for any confusion, Mr. Chairman. The SEC has put out for public comment a proposed rule which would require that banks which engage in public brokerage activities and in-house broker-dealer activities, advice and brokerage, be required to register with the SEC.

Now the practical solution to that is a subsidiary and it could be, as far as we're concerned, a subsidiary of the bank. We have not proposed that they have to set up a holding company or make it insulated from the bank in that fashion.

The CHAIRMAN. What about the SEC's announced program to look into accounting gimmicks being used by some companies to make their financial statements look better? What have you found in that area?

Mr. SHAD. Well, we have found a great deal in that area. A lot of the so-called cooking the books cases that the SEC has been bringing are somewhat a product of the 1982 recession when a lot of companies attempted to temporize the bad news.

We've also adopted specific rules concerning the banks and bank holding companies. Presently, publicly owned banks and S&L's do not file with the SEC; only their holding companies do. But as to the holding companies, we've required greater disclosures on troubled loans and foreign loans where there are liquidity problems.

The CHAIRMAN. So you feel banks are part of the problem, too?

Mr. SHAD. Yes.

The CHAIRMAN. And how do they compare with other companies?

Mr. SHAD. Well, the SEC doesn't presently regulate the banks directly, although it is proposed that they be required to file with the SEC by the Bush task force—but that will require an amendment to the present law, we only see the bank holding companies and I would say on a proportionate basis we haven't seen nearly as many bank holding companies with this problem. But we have less than 1,000 bank and S&L holding companies that file with us, whereas we have 9,000 other companies, so it's not surprising that we haven't seen many.

My impression would be that we haven't had as many cooking the books cases with bank and S&L holding companies, but we have had the problem in terms of the proper disclosure of troubled loans; and we've worked with the Fed in terms of a staff accounting bulletin to proscribe that activity.

The CHAIRMAN. You have been rescued from further oral questions by a vote. We do appreciate your testimony and your willingness to respond to questions very much.

I call a recess of the hearing for a few moments while I go vote and I expect Mr. Ginsburg to be sitting at the table ready to testify when I get back. Thank you very much, Chairman Shad.

[Recess.]

The CHAIRMAN. The committee will come to order.

Mr. Ginsburg, we appreciate your patience, not only during this vote but for rescheduling on such short notice to come back this afternoon. Would you please go ahead?

STATEMENT OF DOUGLAS H. GINSBURG, DEPUTY ASSISTANT ATTORNEY GENERAL, U.S. DEPARTMENT OF JUSTICE

Mr. GINSBURG. Thank you, Mr. Chairman. It's a pleasure for me to be here and it's no inconvenience at all to have been rescheduled.

There is a statement which I have submitted for the record that touches on selective aspects of S. 2181 and S. 2134. That statement will be supplemented by a more detailed letter that you will receive from us fairly soon that will deal with additional aspects of S. 2181.

I'd like to take this opportunity now if I may to highlight just a couple of points of greatest moment to the Antitrust Division of the Department of Justice and then to entertain whatever questions you would like to ask.

JUSTICE DEPARTMENT FAVORS BANKS ACTIVITIES IN INSURANCE, REAL ESTATE, ET CETERA

First, let me say that we are strongly in favor of those provisions of S. 2181 that would enable depository institutions, through their holding companies, to enter various aspects of the insurance, real estate, and securities businesses, as well as other activities that the Federal Reserve Board should determine are of a financial nature. These provisions are very close to the provisions contained in S. 1609. We are very anxious to see legislation of this type enacted. Let me also point out that S. 2134 is less ambitious in this regard and, to that extent, we think less desirable.

Second, we are most anxious to see some positive advancement on the issue of interstate banking and geographic reform. In this respect we have mixed reactions to aspects of S. 2181. In particular, title I would extend application of the Douglas amendment of the Bank Holding Company Act to the ownership of thrifts by bank holding companies and to savings and loan holding company ownership of bank. It would also apply the strictures of the McFadden Act to thrifts that are subsidiaries of a bank holding company.

In each case, that seems to us an unfortunate orientation. We are in an era of increasingly liberal geographic opportunities for financial institutions. Title X of the bill, which endorses State approval of reciprocal banking arrangements and regional banking expansion seems to be much more progressive. We would be anxious to see as much liberalization as possible in the geographic area.

Title X which recognizes the need for expansion across State lines and endorses such State initiatives, is in our view only a partial step toward the ultimate resolution of the interstate banking problem. Ultimately, and as soon as possible we would like to see unfettered opportunities for depository institutions to cross State lines.

The provisions of title X would at least give encouragement to the interstate banking activities that the States have authorized. It is, however, of some concern to us that title X, if viewed as anything more than an interim step, could have somewhat uneven consequences.

Banks in States that are unable to arrange interstate opportunities essentially would be left behind as the country moves toward regional and ultimately nationwide banking. If it is an interim step, then it seems to us at least a step in the right direction.

[The complete statement follows:]

U.S. Department of Justice

Washington, D.C. 20530

STATEMENT OF

DOUGLAS H. GINSBURG
DEPUTY ASSISTANT ATTORNEY GENERAL
ANTITRUST DIVISION

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

CONCERNING

S. 2181, THE "FINANCIAL SERVICES COMPETITIVE EQUITY ACT,"
AND
S. 2134, THE "DEPOSITORY INSTITUTIONS HOLDING
COMPANY ACT AMENDMENTS OF 1984"

ON

MARCH 21, 1984

Mr. Chairman and Members of the Committee:

I am very pleased to have this opportunity to present the views of the Department of Justice on a matter we consider to be of great significance -- reform of the overly restrictive and outdated regulatory system that governs depository institutions in this country. While the efforts of this Committee have begun that process, there is still more to be done.

In recent years, the financial services marketplace has undergone rapid and extensive change. This change has occurred for a number of reasons, including technological innovation, developments in the economy and changes in the needs and expectations of consumers of financial services. Of the various types of financial services firms, depository institutions have been the least able to adjust and respond to this new environment, due to legal restrictions on the products they may offer and the geographic areas in which they may operate. These restrictions not only substantially affect the present ability of these institutions to compete effectively in the new financial services marketplace, they also may endanger the institutions' future viability in the evolving financial services industry. Other types of financial firms have been able to combine a variety of financial services within a single commercial enterprise and to expand on an unrestricted geographic basis. This flexibility has permitted these firms to respond more fully to competitive opportunities and may enable them to achieve economies of scale or scope that could give them a significant advantage over depository institutions.

Some of the regulatory restrictions that in the past significantly hampered depository institutions in their attempts to respond to changing market conditions have now been relaxed or eliminated. The Department has been a principal advocate for maximum reliance on competition in this area. We have urged reform of outmoded statutes and, before the financial regulatory agencies, we have long argued for removal of unnecessary regulatory barriers to competition. In the Department's view, S. 2181, the "Financial Services Competitive Equity Act", would be a positive step toward accomplishing needed additional reforms. Although certain provisions of S. 2181 cause the Department some concern, on balance we favor its enactment.

Critical Areas for Reform

Before focusing more specifically on S. 2181 and another pending proposal, S. 2134, I would like to address in general terms two basic changes in the statutory scheme governing depository institutions that we believe are necessary to maximize competitive interaction in the evolving financial services industry. These reforms are critical if depository institutions, like other financial services firms, are to have the flexibility to respond effectively to the rapid and continuing changes in the financial services marketplace.

First, depository institution holding companies must be permitted to expand into a wide range of financial products and services. We recognize that narrowly limited safeguards may be necessary to protect against certain specific risks - such as adverse effects on the financial condition of depository institution subsidiaries or preferential transactions between depository and non-depository subsidiaries. There is, however, no sound basis for continuing the present broad prohibitions on holding company participation in non-banking financial activities. These prohibitions inhibit the ability of holding companies to achieve their full competitive potential and can result in economic inefficiencies.

Second, existing geographic restrictions on the activities of depository institutions and their holding companies must be eliminated. To the extent these restrictions prevent geographic expansion, they serve only to impede competition by insulating local institutions from out-of-area rivals. To the extent they limit geographic expansion to certain types of activities, they often force firms to resort to contrived and economically inefficient expansion techniques, testing statutory and regulatory loopholes and keeping lawyers and regulators busy.

S. 2181, The "Financial Services Competitive Equity Act", and S. 2134, The "Depository Institutions Holding Company Act Amendments of 1983"

I would now like to focus specifically on S. 2181 and S. 2134 and the extent to which they would effect these needed changes. Following this discussion, I will touch briefly on other aspects of the two bills. More detailed comments on S. 2181 will be contained in a letter we will be submitting to the Committee in the near future.

1. Product Reform

In the area of product deregulation, Title I of S. 2181 is a significant step forward. Like S. 1609, the Administration's bill, S. 2181 would permit bank and savings and loan ("S&L") holding companies to engage in a substantially wider range of financial activities, including insurance underwriting and brokerage; real estate investment, development, and brokerage; and certain expanded securities activities. In the securities area, S. 2181 would also authorize holding companies to deal in and underwrite mortgage-backed securities. In addition, both bills authorize holding companies to engage in other activities "of a financial nature".

We strongly endorse these provisions of S. 2181. They remove unnecessary restrictions on holding company expansion into new financial product areas. Such expansion is necessary in order to spread risk through diversification and to respond more effectively to market forces. At the same time, the approach adopted by the bill separates the holding company's banking and nonbanking activities. Moreover, the bill also expands the existing protections against preferential transactions between a firm's banking and nonbanking operations. These two safeguards should alleviate any concerns that product expansion could adversely affect the safety and soundness of depository institutions or that ownership of a depository institution would give a firm an unfair competitive advantage in nonbanking activities. This approach thus appears to strike an appropriate balance between the need to expand competitive opportunities while guarding against undue risk or abuse.

S. 2134, the other bill under consideration today, is a significantly narrower measure. It would not permit holding companies to expand into new insurance or real estate activities, nor would it authorize participation in activities "of a financial nature." Moreover, the new securities powers it would authorize for bank holding companies would not be available to S&L holding companies. Thus, S. 2134 falls substantially short of S. 2181 in providing needed product expansion reforms.

Although we endorse the product expansion initiatives of S. 2181 and believe them to be an important step forward, we oppose those provisions of Sections 104(d) and 108(b) of the bill that would limit product expansion through acquisition solely on the basis of size. From an antitrust perspective, these limitations are both unnecessary and undesirable.

More specifically, these limitations appear intended to protect against accumulations of "economic power" that might result from acquisitions combining large depository institutions and other financial firms. The underlying assumption is that "big" is necessarily "bad" where banking is to be combined, through acquisition, with the principal new powers granted by the bill, namely insurance, securities and real estate. We disagree with this assumption. Affiliations between firms engaged in related activities can result in increased economic efficiencies without necessarily resulting in adverse competitive effects regardless of the firm's size. Thus, imposing broad prohibitions on proposed combinations based solely on size, without regard to the transactions potential economic effects, could have counterproductive results.

The Department believes that the existing antitrust laws are a more appropriate means of addressing competitive concerns and provide sufficient protection against acquisitions that would result in undue levels of market concentration. As you know, analysis of mergers and acquisitions under antitrust standards requires a precise identification of the relevant product and geographic markets and a careful evaluation of a transaction's likely competitive effects in those markets. Additional restrictions, especially restrictions that fail to take into account likely competitive effects of proposed transactions, are not needed.

Accordingly, we oppose these provision of S. 2181.

2. Geographic Reform

Title I and Title X of S. 2181 address geographic restrictions on expansion by depository institutions. The Douglas Amendment to the Bank Holding Company Act of 1956 currently provides that a bank holding company may not acquire out an out-of-state bank unless the law of the state in which the acquired bank is located permits the acquisition. Title I would extend the existing restrictions on the interstate acquisition of banks by bank holding companies to bank holding company acquisitions of thrifts and to S&L holding company acquisitions of banks. Title I would also extend the McFadden Act's restrictions on branching by national banks to thrift institutions acquired by bank holding companies. Title X would endorse state statutes that permit entry by out-of-state depository institutions but limit that entry on the basis of geographic location or reciprocity.

As indicated earlier, the Department believes that geographic restrictions on expansion by depository institutions must be eliminated if these firms are to remain strong and effective competitors in the evolving financial services marketplace. Elimination of geographic restrictions on a nationwide basis, rather than a piecemeal approach, is the most effective mechanism for reform. Accordingly, the Department has long supported, both before this Committee and elsewhere, repeal of both the Douglas Amendment and the McFadden Act in order to permit expansion where competitive opportunities appear. 1/

The provisions of Title I extend -- rather than relax -- the existing geographic barriers to competition. Accordingly, they embody an approach to regulatory reform that would "level the

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See, e.g., Remarks of the Honorable William French Smith, Attorney General of the United States, to the 71st Annual Meeting of Reserve City Bankers, April 6, 1982, Phoenix, Arizona; Testimony of William F. Baxter, Assistant Attorney General, Antitrust Division, Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, Concerning Competition in the Financial Services Industry, June 8, 1983.

playing field" for financial services firms to the lowest common denominator. The effect on S&Ls acquired by bank holding companies would be especially harsh.

Under existing law, federal S&Ls are permitted to branch statewide and face only limited statutory restrictions on interstate branching. In addition, S&Ls can deploy automated teller machines (ATMs) on a nationwide basis. By imposing McFadden Act restrictions on S&Ls acquired by bank holding companies, Title I would substantially limit their ability to expand by branching and deploying ATMs, thereby placing them at a significant competitive disadvantage relative to S&Ls that are not affiliated with a bank holding company. The general effect of these provisions would be to give new life to regulatory restrictions that were slowly being overcome in the new and healthy competitive environment that the earlier work of this Committee has helped to create.

By contrast, Title X recognizes the need to permit broader opportunities for geographic expansion than currently exist. Title X's approach is merely to endorse state initiatives in this area rather than to provide a federal resolution of this problem on a nationwide basis. While our strong preference is for broad reform that would permit geographic expansion on a nationwide basis, we are prepared, in the absence of such reform, to support an interim step toward that goal that would be effective in relaxing at least some geographic barriers.

The Department views the general approach reflected in Title X as a reasonable interim measure. Increased interstate expansion resulting from state initiatives may diminish opposition to further reform. It should be noted, however, that the state-initiative approach does have the disadvantage of permitting interstate expansion for some firms while precluding it for others. Even state legislation permitting institutions to expand outside that state cannot overcome geographic conditions imposed by other states. By leaving this matter to the states, institutions in states that fail to obtain interstate expansion opportunities may be put in the worst position of all. Those institutions will have no opportunity to expand interstate and therefore, will be least able to adopt to a new banking environment. Indeed, when the institutions in such states are permitted to expand into other states, and they surely will be someday, they may find themselves disadvantaged relative to other institutions that have had an interstate headstart.

While the Department does not object to the state-initiative approach embodied in Title X as an interim first step toward broader, nationwide geographic reform, I would like to emphasize that, in our view, it should be just that -- a first step. The reforms in Title X should increase, not reduce, the impetus for further action to remove all barriers to interstate banking. We therefore urge the Committee to continue to give serious consideration to broader reform measures that would eliminate or substantially relax existing geographic barriers on a nationwide basis.

3. Other Provisions of S. 2181 and S. 2134

Mr. Chairman, before concluding, I would like to touch briefly on two other important issues dealt with by these bills. First, S. 2181 the problem of "non-bank banks." The bill would exclude limited-purpose "consumer banks" from the definition of "bank" in the Bank Holding Company Act and continue but tighten the existing exception for unitary S&L holding companies by creating a so-called "qualified thrift lender" exemption. The Administration is not opposed to providing for a "qualified thrift lender" exemption but believes that, in the interest of competitive equity, the exemption should be kept as narrow as possible and essentially be tied quite tightly to residential real estate lending. The Administration has not yet taken a final position on the consumer bank issue. However, the Department of Justice recognizes the desirable role played by "non-bank banks" and unitary S&L holding companies in spurring innovation and competitive rivalry in the financial services industry. This role has, in part, consisted of offering regulated bank or thrift services in conjunction with other financial services, thereby developing new product mixes with increased convenience for consumers. Such innovations have served consumers well and should be permitted to continue.

On the other hand, we are concerned about creating or perpetuating classes of depository institution holding companies that are free from limitations from their activities when other classes of such holding companies remain subject to restriction on the activities in which they may engage. In short these issues raise the question of whether it is necessary at all to regulate depository institution holding companies, and if these proposals are a step in the direction of removing holding company regulation, we would view them positively.

Second, S. 2134 would amend the Bank Merger Act and the Bank Holding Company Act to permit, with the consent of the Attorney General, the shortening or elimination of the thirty-day waiting period required by those statutes for consummation of mergers or acquisitions that have received regulatory approval. While the Department favors statutory amendments that would provide us with the flexibility to reduce or eliminate the thirty-day waiting period for mergers or acquisitions that are competitively unobjectionable, we believe that there is a much more effective way to achieve this result.

We continue to believe that the Bank Merger Act and related statutes should be amended to remove bank regulators from reviewing the competitive aspects of mergers or acquisitions involving depository institutions. Instead, the competitive aspects of mergers and acquisitions involving these firms, like other financial firms, should be subject to the antitrust laws and the Hart-Scott-Rodino premerger notification procedure. This reform would solve a number of problems associated with the competitive review process required by existing law, including unnecessary delays in consummation of mergers and acquisitions that pose no competitive problems. Bringing depository institution consolidations under the Hart-Scott-Rodino procedures would permit early termination of the thirty-day waiting period and would also accomplish the result apparent goal of these provisions of S. 2134.

Our approach is preferable to the S. 2134 approach for another reason as well. A Government waiver of the thirty-day waiting period (as contemplated by S. 2134) could also arguably extinguish private rights of action under the Bank Merger Act, as the statute of limitations for challenging proposed mergers is, at least for the Department of Justice, coterminus with the waiting period. Therefore, we believe more effective reform would result from our proposal.

Conclusion

In conclusion, I would like to emphasize once again the critical need for further reform of the statutory scheme governing depository institutions. Such reforms are essential if depository institutions, like other financial firms, are to have the flexibility to respond effectively to the rapid and continuing changes in the financial services marketplace. S. 2181 would constitute a major step forward in the area of product expansion. While its provisions dealing with geographic expansion are troublesome from a competitive perspective, on balance, we support its enactment.

Mr. Chairman, that concludes my prepared remarks. I congratulate the Committee's continuing efforts to promote competition and consumer welfare in this important industry. The Department of Justice stands ready to assist the Committee in this important task. I would, of course, be happy to respond to any questions you or other members may have.

United States Department of Justice

ASSISTANT ATTORNEY GENERAL
LEGISLATIVE AFFAIRS

WASHINGTON, D.C. 20530

08 JUN 1984

Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This letter supplements the views of the Department of Justice ("Department") that were presented in testimony before your Committee by Douglas H. Ginsburg, Deputy Assistant Attorney General, Antitrust Division, on March 21, 1984, on S. 2181, the "Financial Services Competitive Equity Act" (the "bill"). We believe that many of the bill's provisions represent significant forward steps in rationalizing the competitive conditions facing depository and other financial institutions. While we believe certain of the bill's provisions should be modified or eliminated, on balance we support enactment of S. 2181. This letter summarizes and discusses those provisions of the bill that are of particular interest to the Department.

I. SUMMARY OF THE BILL

A. Title I

Title I, captioned "Financial Institutions Competitive Equity", is in large part identical to the Administration's bill, S. 1609, the "Financial Institutions Deregulation Act". Like S. 1609, Title I would expand the permissible activities for depository institution holding companies. Both bills would authorize bank and savings and loan ("S&L") holding companies to engage, directly or through a non-depository institution subsidiary, in insurance underwriting or brokerage; real estate investment, development, or brokerage; certain expanded securities-related activities; 1/ and other activities of a financial nature, as determined by the Federal Reserve Board.

Both bills also would permit bank holding companies to acquire thrift institutions and permit S&L holding companies to acquire banks; generally narrow the scope of activities permissible for depository institution service corporations; simplify the procedures for formation of a depository institution holding company involving a transfer of ownership of a bank or thrift institution to a newly-formed holding company to be owned by the same shareholders; and expand (and make applicable to thrift institutions) the existing restrictions on transactions between member banks and their non-bank affiliates.

There are, however, significant differences between the two bills. First, Title I would extend the restrictions contained in the Douglas Amendment, 12 U.S.C. § 1842(d), to bank holding company acquisitions of thrifts and to S&L holding company acquisitions of banks. Sections 104(d) and 108(b). 2/ It would also apply the branching restrictions in the McFadden Act, 12 U.S.C. § 36, to thrifts owned by bank holding companies. Section 104(d). 3/

Second, Title I would not prohibit the ownership of "non-bank banks" by firms that are not depository institution holding companies. 4/ Instead, Title I would create "consumer banks"

1/ These newly authorized securities-related activities would include dealing in, and underwriting obligations issued or guaranteed by or on behalf of, a state or its political subdivisions, including some tax exempt industrial development bonds; sponsoring and operating an investment company; underwriting, distributing, and selling securities of an investment company; and, under Title I only, dealing in and underwriting mortgage-backed securities. Section 104(e)(3) of the bill; Section 11 of S. 1609.

2/ "Extraordinary" or "emergency" acquisitions authorized under Section 13(f) of the Federal Deposit Insurance Act (12 U.S.C. § 1823(f)) or Section 408(m) of the Natonal Housing Act (12 U.S.C. § 1730a(m)) would be expressly exempted from these provisions.

3/ This provision would not apply to branches resulting from acquisitions authorized under 12 U.S.C. § 1730a(m).

4/ Title I would not extend the definition of "bank" in the Bank Holding Company Act to include institutions eligible to become insured banks under 12 U.S.C. § 1815. Thus, it would not bring non-banking firms owning such "non-bank banks" within the definition of a bank holding company.

-- i.e., institutions that would be banks under the Bank Holding Company Act except for the fact that they do not engage in the business of making commercial loans. Section 104(a)(2). The bill provides that a company that owned a consumer bank would not be permitted to acquire a consumer bank located in another state unless (1) the acquisition of a consumer bank by a company owning a consumer bank in another state is expressly permitted by the statutes of the home state of the consumer bank being acquired, (2) the acquisition of a bank by a bank holding company is expressly permitted by the statutes of the consumer bank's home state, or (3) the acquisition of an industrial bank or other similar institution by a company is expressly authorized by the statutes of the consumer bank's home state. Section 104(b)(2).

Third, while Title I, like S. 1609, would limit unitary S&L holding companies to the same activities permitted for multiple S&L holding companies, Title I would exempt from these limitations those unitary S&L holding companies whose sole insured institution subsidiary is a "qualified thrift lender." Section 108(b). 5/

Fourth, Title I would prohibit a bank holding company from acquiring a firm engaged in non-banking activities permissible for bank holding companies if (1) the consolidated domestic deposits of all banks owned or controlled by the holding company represent at least .30 percent of all domestic deposits in the United States, and (2) as a result of the acquisition, the holding company's investment in any one of the permissible non-banking activities would exceed 25 percent of the holding company's consolidated capital. Section 104(d). Title I would also prohibit, under the same criteria, the acquisition of one or more banks by a non-depository institution engaged in activities permissible for bank holding companies. Id. 6/

Finally, Title I would preempt state laws authorizing state-chartered banks to engage in out-of-state insurance activities on a basis different from in-state insurance activities, Section 104(h),

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5/ The term "qualified thrift lender" is defined as an insured institution that (1) has not more than 25 percent of its assets invested in commercial and certain commercially related loans, or (2) has not less than 60 percent of its assets in loans or securities related to residential real estate or manufactured housing and property used by an insured institution in conducting its business. Id.

6/ These prohibitions would also be imposed on acquisitions involving insured institutions or S&L holding companies, and companies engaged in permissible non-banking activities. Section 108(b).

and would add to the antitying provisions of 12 U.S.C. 1971 et seq. certain disclosure and other requirements concerning credit-related insurance, Section 107(2).

B. Titles II through X

The other titles of the bill contain extensive statutory revisions as well. The Department's comments will focus on only three of these titles.

Title V would essentially repeal the Consumer Leasing Act of 1976, 15 U.S.C. §§ 1667-1667e, and add to the Consumer Credit Protection Act, Pub. L. No. 90-321, 82 Stat. 146 (codified as amended in scattered sections of 15 U.S.C.), a new title covering consumer leasing and rental-purchase agreements. Title IX, which deals with the fraudulent use of credit and debit cards, would amend Section 134 of the Truth in Lending Act, 15 U.S.C. § 1644, and Section 916 of the Electronic Funds Transfer Act, 15 U.S.C. § 1693n, to expand the scope of illicit activities under those statutes.

Title X concerns interstate expansion by depository institutions. This title expressly provides that a state that permits the acquisition of banks located in that state by out-of-state bank holding companies may limit that authority to holding companies located in particular states, on the basis of such factors as the geographic location or proximity of the other states or reciprocal treatment by those states for holding company acquisitions. The title contains similar provisions concerning branching by out-of-state banks, as well as parallel provisions applicable to S&Ls and S&L holding companies. The title also includes a sunset provision that would become effective five years from the date of its enactment. In addition, it calls for the submission of a report to be transmitted to Congress by the President, in consultation with the Attorney General, the Secretary of the Treasury, and the three federal depository institution regulatory agencies, on the effect of the title on the financial, economic, and banking environment and on particular depository institutions and holding companies. The report is to be transmitted not later than four years from date of enactment of the title, and is to include legislative recommendations as to whether the sunset provisions of this title should be allowed to take effect.

II. DISCUSSION

A. Title I

In general, Title I would significantly enhance competition in the financial services industry by reducing the competitive distortions arising from unnecessary and overly extensive regulation. For example, depository institution holding companies would be authorized to engage in a wider range of financial activities. Moreover, Title I would eliminate the restrictions recently imposed by the Garn-St Germain Act on insurance activities of bank holding companies. 7/ We believe these and other provisions in Title I would be positive steps, continuing needed regulatory reform of this industry.

Title I of S. 2181 is significant in two principal ways when compared to S. 1609. First, Title I would authorize depository institution holding companies to engage in an additional securities-related activity not available under S. 1609 -- dealing in and underwriting mortgage-backed securities. We endorse these provisions. Second, Title I would permit the continued existence of "non-bank banks" and would continue to exempt unitary S&L holding companies owning limited-purpose institutions from broad prohibitions on non-banking activities. These latter measures would allow the continuation of one form of competitive pressure that has spurred innovation and rivalry in the financial services industry. 8/

Title I, however, also represents a significant step backward from S. 1609 in two principal respects. The Department opposes those provisions of Title I that would extend existing restrictions on geographic expansion, as well as the provisions imposing size limitations upon expansion into new product lines through acquisition. On balance, however, because the benefits of Title I outweigh its shortcomings, we generally support its enactment.

7/ Section 601 of the Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1496, amending 12 U.S.C. § 1843(c)(8).

8/ As stated in Mr. Ginsburg's testimony, the Administration has not yet taken a final position on the consumer bank issue. We recognize that they are a positive source of innovation and competition, and we believe such innovations have served consumers well and should be permitted to continue. We are, however, concerned about creating or perpetuating classes of depository institution holding companies that are free from limitations on their activities when other classes of such holding companies remain subject to restriction on the activities in which they may engage. In short these issues raise the question of whether it is necessary at all to regulate depository institution holding companies, and if these proposals are a step in the direction of removing holding company regulation, we would view them positively.

1. Geographic Restrictions

Under section 104(d) of the bill, bank holding company acquisition of an out-of-state S&L would be subject to the restrictions of the Douglas Amendment as if the S&L were a bank, and branching by an S&L acquired by a bank holding company would be subject to the same geographic limitations imposed by the McFadden Act on branching by national banks. 9/ The Department has repeatedly urged that the anticompetitive restraints imposed by the Douglas Amendment and the McFadden Act on geographic expansion be eliminated or at least substantially reduced. 10/ We therefore must oppose any provisions extending the reach of these statutes.

Under existing law, federal S&Ls can branch statewide and face only limited statutory restrictions on interstate branching. 11/ Moreover, S&Ls can deploy automated teller machines ("ATMs") on an interstate basis without restriction, thus permitting utilization of electronic banking technology in the most efficient manner.

9/ The applicable provisions of section 104(d) also pertain to other "insured institutions" -- that is, other institutions insured by the Federal Savings and Loan Insurance Corporation and federal savings banks and stock savings banks insured by the Federal Deposit Insurance Corporation.

10/ See, e.g., Remarks of the Honorable William French Smith, Attorney General of the United States, to the 71st Annual Meeting of Reserve City Bankers, April 6, 1982, Phoenix, Arizona; Testimony of William F. Baxter, Assistant Attorney General, Antitrust Division, Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, Concerning Competition in the Financial Services Industry, June 8, 1983 ("Baxter Testimony").

11/ The Garn-St Germain Act for the first time imposed statutory limitations specifically applicable to interstate branching by federal S&Ls. Section 334 of the Act, 12 U.S.C. § 1464r, provides that a federal S&L may branch outside its home state if it (a) qualifies as a domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code ("Code"), 26 U.S.C. § 7701(a)(19), or (b) meets the asset composition test set forth in section 7701(a)(19)(c) of the Code, 26 U.S.C. § 7701(a)(19)(c). In addition, the S&L's out-of-state branches must comply with certain Code-related criteria. Section 334 also provides several exceptions that permit the operation of out-of-state branches regardless of whether any of the Code standards are met. For example, a federal S&L may branch out-of-state if so permitted by the laws of the state in which the branch is to be located.

Section 104(d) would materially and adversely affect each of these powers for an S&L acquired by a bank holding company, thereby placing the acquired S&L at a significant competitive disadvantage to other S&Ls not so affiliated. First, S&Ls acquired by bank holding companies would, under section 104(d), be subject to the frequently restrictive branching limitations imposed by the various states on banks. Thus, in some states, these S&Ls would be permitted to branch only on a limited basis and in other states would not be permitted to branch at all. 12/ Second, since national bank ATMs are "branches" for purposes of the McFadden Act, 13/ S&Ls owned by bank holding companies would be permitted to deploy ATMs only at locations at which they could operate a branch office. 14/

In sum, these provisions endorse an approach to regulatory reform that would limit the geographical expansion opportunities of financial institutions to those of the most restricted institutions. The Department believes this approach to be unsound and therefore is opposed to it.

Title I of the bill would also apply the restrictions contained in the Douglas Amendment to S&L holding company acquisitions of banks. Section 108(b). Section 104(b)(2) would impose similar restrictions on the acquisition of a consumer bank by a company owning a consumer bank located in another state. These provisions, like those of section 104(d), would inhibit geographic expansion, thereby impeding the ability of holding companies to compete and spread risk through geographic diversification. Indeed, the extension of geographic restrictions to the ownership of consumer banks would introduce a new anticompetitive dimension to the existing depository institution regulatory scheme. It would, for the first time, impose significant limitations on interstate expansion by a firm whose only bank subsidiary is a "non-bank" consumer bank and which therefore would not fall within the statutory definition of a bank holding company. Thus, if consumer banks are authorized, their opportunities for expansion by acquisition should not be subjected to geographic restrictions.

12/ Nine states currently prohibit bank branching entirely; 20 states permit only limited branching. Bank Expansion Reporter, October 17, 1983, at 3.

13/ Independent Bankers Ass'n of America v. Smith, 534 F.2d 921 (D.C. Cir. 1976), *cert. denied sub. nom.* Bloom v. Independent Bankers Ass'n of America, 429 U.S. 862 (1976).

14/ The Department has recommended that ATMs be explicitly removed from the reach of the McFadden Act. See Baxter Testimony at 8.

2. Product Restraints

Title I of the bill also has serious flaws in the product expansion area. Sections 104(d) and 108(b) would prohibit certain acquisitions involving depository institutions or their holding companies on the one hand, and firms engaged in permitted non-banking activities on the other. One of the two tests to be applied is whether the banks or thrifts involved have consolidated deposits equal to or exceeding .30 percent of all domestic deposits in the United States. The second test is whether, as a result of the acquisition, the depository institution holding company would have more than 25 percent of its consolidated capital in any one non-banking activity. If both tests are met, the acquisition would be prohibited.

These provisions seem to be intended to guard against concentrations of economic power that might result from acquisitions involving large depository institutions and large insurance, securities, or other financial firms. In the Department's view, the prohibitions imposed are neither necessary nor desirable from an antitrust perspective. Rather, we believe that the existing antitrust laws are far superior to address competitive concerns and provide sufficient protection against acquisitions that would result in undue levels of market concentration. Thus, additional restrictions are not needed. Moreover, in some instances, affiliations between large firms engaging in related activities can result in increased economic efficiencies without posing significant anticompetitive risk, and the antitrust laws take this possibility into account as well. The bill's imposition of broad prohibitions based solely on size, without regard to likely competitive effects or potential economic benefits of proposed transactions, could have counterproductive results and distort the efficient operation of markets for specific products and services.

Furthermore, these provisions are definitionally flawed. The term "deposits" is not defined. It is therefore unclear whether, when determining the dollar amount of "all domestic deposits in the United States", the term is intended to include, for example, the deposits of all banks and thrifts, all federally-insured deposits, including those held in credit unions, or all deposits, whether or not federally insured.

For the above reasons, the Department opposes these provisions and believes they should be eliminated.

B. Other Titles

Title V, the "Consumer Lease and Rental-Purchase Act", involves policy considerations as to which the Department expresses no views, with one exception. Section 133 of Title V's proposed new title to be added to the Consumer Credit Protection

Act would require the Attorney General and the Federal Reserve Board to submit annual reports to Congress regarding the administration of the title. The Department believes that a statutorily required report from the Attorney General is unnecessary, particularly when section 133 would also require the Federal Reserve Board, the agency charged with writing regulations under the title, to submit an annual report. Adequate means are available for submission of recommendations and information to the Congress without requiring a formal report by the Attorney General.

Title IX, which would expand the scope of federal legislation covering the fraudulent use of credit and debit cards, would address several problem areas not adequately addressed under existing law. Title IX is quite similar to a bill prepared by the Department and sent to the Congress earlier this year. The Department supports the changes to existing law reflected in Title IX.

Title X, the "Interstate Banking Act of 1983", would, if enacted, give Congressional endorsement to the concept that states willing to permit entry by depository institutions and their holding companies from some states, but unwilling to permit such entry from all states, could limit entry on the basis of such factors as the geographic proximity of, and/or reciprocal arrangements with, other states. The Department has serious reservations concerning the effects of Title X.

While the Department believes that reciprocity may be a reasonable basis on which a state may condition entry, we are concerned that state adoption of geographic requirements for entry might result in the exclusion of some states from participation in interstate banking arrangements. Thus, although depository institutions and their holding companies located in states participating in regional arrangements would be permitted to expand throughout the region covered by the arrangements, firms located in a neighboring state excluded from such an arrangement would be denied entry into those states, notwithstanding that they might be, on the ground of economic efficiency, likely candidates for such entry. Thus, the creation of regional barriers endorsed by Title X could lead to new competitive problems as firms seek to insulate themselves by statute from outside competitors. Indeed, the clear intent of state statutes limiting entry on a geographic basis is to provide such protections rather than to let the marketplace develop without artificial impediments.

The Department believes that elimination of geographic restrictions on a nationwide basis, not a piecemeal state-by-state approach, is the goal to be sought by geographic reform. 15/ Our reservations concerning Title X are based not only on its adoption of the piecemeal state-by-state approach, but also on our concern that enactment of the title would diminish the incentive to remove or substantially relax through federal legislation the geographic barriers imposed by the Douglas Amendment and the McFadden Act. In light of the rapid changes taking place in the financial services marketplace, further delay of broad geographic reform would serve only to increase the economic distortions resulting from these geographic barriers to competition.

While we do have serious reservations concerning Title X, we also recognize that it may encourage continued innovation at the state level that could provide a strong basis for broad nationwide geographic reform. With the increased experience in interstate expansion that may result from state initiatives in this area, opposition to further reform may be diminished as its competitive benefits become more apparent. It is on this limited basis, as an interim step toward broader, nationwide geographic reform, that the Department does not oppose Title X.

III. CONCLUSION

This statement of the Department's views on the bill has focused principally on Title I, which constitutes a major portion of the bill. While we oppose the provisions extending geographic restrictions and imposing size limitations on acquisitions, we believe there are substantial competitive benefits to be gained from the product expansion initiatives of Title I. Thus, on balance, we support Title I.

The Department also supports Title IX, which we believe would effect positive changes in existing law. We do not oppose Title X, on the basis that it would represent an interim step toward broader, nationwide geographic reform.

15/ For example, S. 2107 provides for a phased-in elimination of the barriers to interstate expansion imposed by the Douglas Amendment on bank holding companies. That bill would permit bank holding companies, each year for a five year period, to acquire a bank in each of two additional states selected by the holding company. Although a state could by statute or voter initiative prevent such entry by out-of-state holding companies, that state's own bank holding companies would be prohibited from acquiring banks in other states. Five years after enactment of the bill, the Douglas Amendment would be repealed. Although S. 2107 does provide for geographic reform on a national basis, its coverage is limited to interstate expansion by bank holding companies. It would not relax barriers to interstate branching imposed by the McFadden Act, nor would it eliminate geographic limitations or expansion by thrift institutions or their holding companies.

We express no views on the remaining titles of the bill, with the exception of Title V, with respect to which we express our concerns regarding section 133. With that exception the Department has no objection to enactment of the remaining titles of S. 2181.

The Office of Management and Budget has advised this Department that there is no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

Robert A McConnell

Robert A. McConnell
Assistant Attorney General

The CHAIRMAN. Thank you very much.

You emphasize the need to remove barriers keeping banking organizations from competing nationally across State lines, and I'm sure you've heard the arguments on both sides. The arguments at this time as far as the number of votes in the Senate fall almost totally on the side of not allowing what you recommend to take place. The arguments are about the local interests, the fear of undue concentration by large institutions, that decisions ought to be made at the local level and not in the money market centers of this country, and that if similar things would happen in the money market funds so much money would flow out of the small institutions in rural areas of this country to the money market centers that we must therefore preserve the status quo.

How do you feel about those arguments? What do you think would happen if suddenly we repealed McFadden and had interstate banking? Do you share these concerns?

Mr. GINSBURG. I think there is at least some basis in experience that can enable us to put these concerns into perspective. And put into the proper perspective, one can only conclude that it is inappropriate to hold back the tide of progress on the interstate banking issue, because of fear of what will happen.

When the States moved toward internally liberalized branching rules—for example, when New York moved from regional to statewide branching—it was not that easy for money center banks to open branches in small communities in upstate New York—and simply to sweep aside local competition. In fact, a good deal of retrenchment occurred in the case of the New York banks' upstate efforts. I think similar experience comes out of the State of Virginia.

That experience suggests to me that local banks will continue to play a very important role and that the advent of interstate banking will simply provide additional alternatives to consumers in local markets. It will provide additional competition that will probably spur local banks to become more efficient and better able to serve their local communities. It does not seem to be in any one's interest, including the money center banks, to attempt to go into a community and operate a business without regard to the demands of the local consumers in that community. So I would not expect the worst fears of the critics of interstate banking to be realized.

With respect to undue concentration, Mr. Chairman, I think it's important to bear in mind that removal of the interstate banking restrictions would leave depository institutions subject to the antitrust laws as embodied either in the Bank Merger Act or the Bank Holding Company Act, or if those acts were amended, subject to the general strictures of the Clayton Act. That will enable the Department of Justice to evaluate proposed acquisitions from the point of view of undue concentration in particular markets and to prevent any mergers or acquisitions that are likely to have adverse effects on competition.

I understand that the phrase "undue concentration" is often used by critics in this area as well as others to refer simply to what we would call mere asset aggregation—that is to say—the mere size of the institution. So far as antitrust considerations go, mere size is not relevant to market performance or to concerns about likely anticompetitive behavior.

There are very large firms that may have grown large because they are more efficient than smaller firms, in this industry as well as in others, and their absolute size is not relevant to any inquiry about potential competitive effects.

If I can move to a closely related aspect of this, the provision of S. 2181 that would limit holding company acquisitions on the basis of absolute size seems to us unwarranted for the reasons I've just given.

The idea that a bank holding company should not be allowed to acquire, let us say, an insurance affiliate where the resulting consolidated firm would have more than 25 percent of its capital in the insurance arm of the company places an arbitrary rather than a competition-oriented ceiling on acquisitions that really could better be addressed on a case-by-case basis by application of the antitrust laws.

VIEWS ON DUAL BANKING SYSTEM

The **Chairman**. What is your view of the dual banking system? Do you think it has benefits and should be preserved?

Mr. **Ginsburg**. I think the dual banking system has served us well. It is an example of a special type of competition, of course, regulatory competition, in the sense that there are options for depository institutions to be regulated under either State or national law. I think competition in this area, as in the commercial arena, has provided an essential and useful discipline on the regulatory agencies.

I would not want to see the dual banking system jeopardized and I don't think that interstate banking poses a significant threat to the dual banking system.

The **Chairman**. This morning Chairman Isaac recommended more vigorous antitrust enforcement under revised antitrust laws as the way in which the banking system would remain diverse and avoid concentration. He suggested that the largest banking organizations be permitted in a new geographic market on a de novo basis or through a foothold small institution acquisition. He said competitive benefits of the new entrant would be reduced if the large bank was permitted to acquire one of the largest competitors in the market.

You stated that you think existing antitrust enforcement standards are adequate. What is your view of Chairman Isaac's statements this morning?

Mr. GINSBURG. If a financial institution is limited in the means by which it could enter a new market to a de novo entry or a toehold acquisition, it would of course, mean that every entry would be demonstrably procompetitive and introduce a new competitor into the market.

However, if institutions are allowed to enter new markets by the acquisition of existing institutions that are above the so-called toehold level, that would provide additional opportunities for procompetitive entry because it would enable more institutions to enter those target markets and to do so by acquiring existing banks and other depository institutions that have potential for improved performance under new management.

If the new entrant is allowed to enter only de novo or by toehold, there will undoubtedly be fewer interstate entries simply because there's a limit on the number of institutions that will be attracted into any one area.

If that out-of-State institution is allowed to acquire a sleepy or poorly managed institution and to improve its management, that is just as procompetitive as a new entry and should not be discouraged. It should, of course, be evaluated under the antitrust laws.

The CHAIRMAN. We've heard testimony and comments that one section of my bill, which allows interstate regional banking compacts to legalize or clarify the constitutional situation on the New England situation, would so-called balkanize banking; it would just serve to keep out large banks while appearing to provide progress. Do you agree?

Mr. GINSBURG. Mr. Chairman, I think that the regional compact approach, as limited to the 5-year period specified in your bill would not have that sort of deleterious balkanizing effect in the long run because it is responsive to the need to reexamine interstate banking 5 years after enactment of the bill.

However, if the regional solution were to become permanent, then I think there would be more force to the concern to which you have just referred.

There are banks in some States that will be excluded from interstate banking opportunities because of their competitive vigor, perhaps by neighboring States whose bankers do not invite that form of efficient competitor into their borders. Thus, the penalty will be levied perhaps against the most efficient of our institutions if the regional approach were left in place in the long run.

The CHAIRMAN. We commonly hear that interstate banking is already here and I've talked about it many times and I certainly agree that it is—legal interstate trust operations, mergers of troubled institutions across State lines. We also have loan generation offices, finance companies across the country, and, of course, you've got all of those new types of institutions that aren't banks that have acquisitions throughout the country, no geographical barriers at all.

So if we assume the fact that it is already here, at least in some form, what benefits would come from dismantling the formal barriers to taking deposits across State lines?

Mr. **Ginsburg**. At present, consumers are faced with the opportunity to deal with out-of-State institutions on an exceedingly uneven basis, depending upon where they happen to be located. There are, of course, as you said, examples of interstate holding companies, some of which were grandfathered when the 1956 act was passed, others of which have been created through supervised mergers over the last several years. There are States in which industrial banks have been acquired by out-of-State holding companies. But the results have been extraordinarily uneven. I hesitate to say haphazard.

They have rewarded those who have been innovative in exploiting loopholes in the law and then achieving grandfather status if the loophole is closed. They have undoubtedly tended to provide more opportunities for the largest institutions rather than smaller institutions to branch or extend their reach interstate.

So we have holding companies, such as Citicorp, with operations in many States serving consumers in a variety of locations, and then perhaps a bank in Kansas City, Kans. which is unable to open a branch in Kansas City, Mo., notwithstanding the fact that there may be consumer demand for that sort of interstate service.

So I think there are many gaps in the present pattern of interstate banking that are left to be filled both to put competitors on a more even basis and to allow consumers full access to the benefits of interstate competition.

The **Chairman**. This morning we had a great deal of talk about brokered deposits and it's my understanding that Justice has opposed the FDIC and the FSLIC in its proposed rule.

OPPOSITION TO BROKERED DEPOSITS RULE

Would you comment on Justice's opinion on brokered deposits and specifically your opposition to the rule?

Mr. **Ginsburg**. Certainly. We filed comments in opposition to the proposed rules because those rules seemed to us demonstrably overbroad in relation to the problem to which they are directed.

The problems caused by brokered deposits, as they have been identified by the agencies who have proposed this rule, are ones that affect a very small number of institutions that have found themselves in difficulties or with a liquidity problem and have turned to brokered deposits for a solution to their problems.

Our understanding is that the number of institutions in that condition is very, very small, whereas the rule would have general application and would essentially stop nationwide activity that has benefited hundreds, if not thousands, of depository institutions without in any way jeopardizing their solvency. So we suggested that a rule more narrowly tailored to the problem be enacted rather than the rule that has been proposed.

To take one of many possible approaches, brokered deposits could be regulated, prohibited or scrutinized with reference only to institutions that have received a rating in the lowest two categories—for instance, in the 4 or 5 category CAMEL rating system used by the regulators. There is really no need to stop the activity on a broad nationwide scale.

The CHAIRMAN. Getting back to the broader question of deregulation, I've received criticism that deregulation has resulted in benefits to the affluent, higher bank fees and service charges, and closed branches specifically for lower income groups and lower income neighborhoods.

Would you respond to those types of criticisms to not only current deregulation, but what we're proposing?

Mr. GINSBURG. I think it's very difficult to identify with any confidence or precision the causal connection between deregulation in any industry and particular aspects of its performance when there are so many variables at work besides deregulation.

In the financial area, I think the two phenomena of branch closings and of higher service fees, to which you referred, certainly reflect the reorientation of our financial institutions to a greater emphasis on fee-based income, and to adaptation to more volatile interest rates. But to trace the more volatile interest rates and higher interest rates to financial deregulation, as opposed to monetary policy or other secular shifts in the economy, seems to me not only speculative but in this case rather dubious.

The effects one would expect from interest rate deregulation have probably brought about a transaction cost saving so that people who had previously had to take, let us say, evasive measures in order to circumvent regulations that used to be in effect are now able to obtain market rates of interest without incurring the cost of those evasive activities. That should, if anything, drive down the cost of doing business and result in a net saving for society. So I would think that if interest rates have gone higher, it's not because of, but in spite of, the deregulation efforts that you have had so much to do with over the last several years.

The CHAIRMAN. Mr. Ginsburg, we appreciate your testimony very much. I have no additional questions at this time.

Do you have any closing comments you wish to make?

Mr. GINSBURG. Thank you, Mr. Chairman. I would just like to take this opportunity to thank you for your efforts in the deregulation movement to date and to wish you every good fortune with the effort currently underway. We are strongly in favor of your work.

The CHAIRMAN. Thank you.

The next hearings in this series will be Tuesday, March 27, when Chairman Volcker will be the witness, and Wednesday, March 28, when Secretary Regan will testify. Those are the last of the scheduled hearings on these two bills. However, it is possible, as happened with S. 1720, that when we go through all of the testimony that we've received over the last few weeks, that we may want to schedule some additional hearings on specific aspects of the bill. But at this time, those are the last two that are formally scheduled.

The committee is adjourned.

[Whereas, at 2:45 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

RESPONSE TO PROPOSED LEGISLATION, TITLE VI OF S. 2181

HOUSTON CLEARING HOUSE ASSOCIATION
ORGANIZED OCT. 1891
717 TRAVIS, SUITE 600
HOUSTON, TEXAS
77002

FRED J. REDEKER
EXECUTIVE VICE PRESIDENT

(713) 223-3836

April 12, 1984

Senator Jake Garn, Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
S.D. 505, Dirksen Senate Office Building
Washington, D. C. 20510

RE: Fair Deposit Availability Act

Dear Mr. Chairman:

We are writing to you in regard to legislation being considered by Congress addressing the availability policies of depository institutions of the United States. The Houston Clearing House Association, in its efforts to monitor vital issues pertaining to the banking industry, has surveyed its members to determine their availability policies.

The attached report covers the issues that are currently drawing consideration from Congress, consumer groups, and the banking industry. The survey results show that our member banks, without legislation or regulation, are conscientiously responding to the needs of our customers in this sensitive area. Even prior to efforts undertaken by the American Banking Association and the Federal banking regulators to insure that institutions were disclosing their "HOLD" policies, over 90% of our members were already taking this action. Many of our members, after hearing the results of our survey, have already decided to shorten "HOLDS" on the small number of deposited checks that require this action. Our findings that interest is credited immediately to interest-bearing accounts also supports our position that the free market system is operating effectively to achieve the results desired by banking customers.

Based on our findings, we strongly urge Congress to avoid the imposition of what we perceive to be unnecessary regulatory control at this time.

We respectfully request that you include this letter, communicating our position and the results of our survey, in the testimony that your committee is considering in regard to this question.

Sincerely,

Fred J. Redeker

FJR/pj

HOUSTON CLEARING HOUSE ASSOCIATION

SUMMARY OF SURVEY ON FUNDS AVAILABILITY POLICIES

The following is a summary of the results of a survey on funds availability policies conducted by the Houston Clearing House Association. The response to the survey has overwhelming: 240 surveys were sent out and 172 banks responded, which translates into a 72% response rate. This response is indicative of the growing awareness and interest, on the part of the banking industry, in the issues dealing with funds availability.

The survey showed that 97% of the respondents place "HOLDS" on certain types of checks that are deposited in their institution. The banks emphasize, however, that they minimize the use of "HOLDS" to the extent consistent with the safety and soundness of the bank, and the avoidance of unnecessary losses to the bank. Also, while 97% of the banks responding to the survey said they placed "HOLDS" on deposited checks, the number of "HOLDS" actually placed on a daily basis is minimal. Approximately one-tenth of the 1% of deposited checks have "HOLDS" placed on them.

In regards to the issue of disclosure, more than 90% of the responding banks inform their customers of "HOLD" policies any time they are placing a "HOLD" on a deposited check. Approximately 80% of the banks currently inform their customers of "HOLD" policies when opening a new account. In addition, other methods of disclosure, such as lobby signs, statement stuffers, and statements on deposit receipts, are used to maintain customer awareness that "HOLD" policies are in existence.

The survey also revealed some specific facts about the length of these "HOLDS". For local (Houston) items, 86% of the responding banks place a "HOLD" of five days or less. For items drawn on banks in Texas but outside of Houston, 95% place "HOLDS" of 10 days or less. On out-of-state items, 98% of the banks place "HOLDS" of 15 days or less.

The banks stress that their "HOLD" policies are based primarily on return time which can be considerably slower than the original presentment time. For example, just the return of a local item could result in a four-day time period if the item being returned were mailed over a weekend. Again, it is important to remember that even though 1% of checks are returned for insufficient funds, "HOLDS" are still only placed on one-tenth of 1% of checks deposited.

Banks delay availability of funds from checks deposited in accounts for a variety of reasons, basically to insure that the bank has recourse. Criteria used as guidelines for placing "HOLDS" include:

A. Insurance or other draft
(Returns because of improper endorsements and the frequency of stop payment orders)
B. Unknown maker of check
C. Length of time an account has been opened
(six months to a year minimum)
D. How the account has been handled
i.e. number of NSF and overdrafts
E. The average collected balance of account
F. New account deposits
G. Type of check being deposited
(more personal checks are returned than others)
H. Two-party endorsements
I. Unusually large deposit for that account
J. Location of paying institution
K. Deposit of check with low check number
(from an account unknown to the depositing bank)

In addition to protecting the bank, "HOLDS" protect the customer as well. A "HOLD" avoids the possibility of the customer spending funds that are in fact not good funds, placing that customer in the position of repaying the bank.

Besides protecting the bank and customer, "HOLDS" help reduce the risk of check kites and other check schemes, and checks being returned for insufficient funds, closed account, forgery, etc. The Houston Clearing House Association operates a New Accounts Reporting Center with approximately 300,000 names on file showing the preponderance of NSF check writing. Our statistics show that about 9% of new account applicants checked against the Association's system, are chronic bad check writers, thus reinforcing the banks' need to exercise caution in accepting checks for deposit.

A note about interest-bearing accounts: In addressing these accounts banks stated that deposits into interest-bearing accounts earn interest as soon as the deposits are made, whether a "HOLD" is placed on the deposit or not.

In conclusion, the survey results indicate that the Greater Houston banking industry, in response to market pressures and experience with the check processing system, is addressing the issue of funds availability. The majority of the responding banks are already disclosing their "HOLD" policies in some fashion. The number of days the funds are held before they are made available is reasonable in light of the time it takes to return the item.

COMPETITIVE EQUITY IN THE FINANCIAL SERVICES INDUSTRY

PART III

TUESDAY, MARCH 27, 1984

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Mattingly, Hecht, Proxmire, Riegle, and Dixon.

OPENING REMARKS OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today we continue the hearings on S. 2181 and S. 2134, the financial institutions competitive equity legislation. We are down to the next to last hearing in the originally scheduled hearings on these acts and we are very pleased to have the Chairman of the Federal Reserve with us this morning, Paul Volcker, who started these hearings in Salt Lake City on January 16.

We've had a good deal of testimony and a lot of discussion over the last 2 months and we appreciate you being here and being willing to testify again at the conclusion of these hearings.

Please proceed.

STATEMENT OF PAUL VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you, Mr. Chairman. I will read only portions of my statement. Some of it is rather detailed but the details may be important. I do note that we had some preliminary hearings last year on this subject and you have had many hearings since then. I simply would say that there is an urgency for action, and I think, on the hearing record, you have a basis for your deliberations and actions.

FIVE CRITICAL AREAS OF THIS LEGISLATION

My testimony basically touches on five points: A strengthened definition of bank; a definition of qualified thrift; new procedures to streamline application of the Bank and Thrift Holding Company Acts; the powers of depository institutions holding companies; and statutory guidelines to govern the division of State and Federal authority in the area of banking organization powers. I think these are the five critical areas in the legislation, the first three of which seem to me in concept not controversial, broadly supported by the testimony before you. They are controversial in some of the details, but it seems to me the concepts are pretty well accepted. I cannot say that for all the powers portions of the bill nor probably the provisions dealing with State-Federal relationships.

We take as a point of departure, of course, the idea that there is something unique and special about banks that has been reflected in the Federal protections, the so-called Federal safety net around the banking system, for which a certain amount of regulation and insulation is necessary. I think that broad philosophical concept is pretty well accepted and that's what we're dealing with in the definition of a bank.

In terms of the definition of a bank that we propose and is incorporated in a number of the bills before you, let me say some question has arisen about the net being spread perhaps a bit too widely to cover some industrial loan companies and some nonfederally insured S&L's, and the proposals that we make in this testimony deal with those questions and in effect suggest an exemption for certain industrial banks that do not have transactions accounts but otherwise would be eligible for insurance and indeed are eligible for insurance. If they do not carry transaction accounts I think they could be exempted from the coverage of the definition of a bank without substantial harm.

As far as nonfederally insured S&L's are concerned, I believe with the broad powers that the S&L's have, the proposed definition would pick up some of these. As to the question whether it's necessary, we suggest that if a State or privately insured S&L meets the test of a qualified thrift, which I'll get to in a moment, they could be exempted from the definition of a bank essentially on the same basis that federally insured thrifts would be exempted, under a procedure of State certification that they, indeed, are following those rules.

Those two changes would take care of the more or less technical problems that have been brought to our attention since this definition was proposed.

We do not believe that we should exempt the so-called consumer bank from a definition of a bank. That proposal is contained in your bill, Mr. Chairman, S. 2181. It would allow a consumer bank to take all forms of deposits, including transaction accounts, and make consumer loans, as well as a wide variety of other types of credit extensions, including some commercial loans.

It is our feeling that that approach would permit commercial and industrial firms to enter into essentially depository institution activities, including access to the payments system, in a manner that would inevitably undermine the public policy objectives incorporated in the Bank Holding Company Act, and it would certainly be the appearance and the reality of unfair competition with banks that are subject to the act.

Our concern is that the regulated banking sector would inevitably wither and much of the banking business would take place in institutions not subject to all those policy restrictions incorporated in the act about risk, conflicts of interest, and concentration of resources. We're already beginning to see that kind of migration today into unregulated forms, and I would point out that 19 percent of commercial banks now have commercial loan portfolios, using a narrow definition of commercial loans as in the bill, equal to not more than 5 percent of assets, and that 47 percent have 10 percent or less of their assets in this form. Thus, almost half the number of commercial banks in this country could, with some minor restructuring of their portfolios, conduct basically the same activities as they do today but escape policies of the Bank Holding Company Act.

I might say too, in considering the appropriate definition of a bank, we do not think there should be extensive grandfathering of all those institutions that have undertaken these new corporate forms over the recent period.

CONCEPT OF A QUALIFIED THRIFT

As far as the definition of a thrift is concerned, and more precisely a qualified thrift, we are dealing in an area where a number of States are providing State-chartered thrifts with essentially the full panoply of banking powers and, indeed, in many cases, they go well beyond that. So there are institutions with no restrictions on the activity of the parent firm; at the same time, of course, they can obtain long-term Government sponsored credit, favorable tax treatment, and a freedom to branch intrastate and interstate while all those privileges are denied commercial banks. So I think there is an urgent need for adopting some rules to assure equality of treatment of various kinds of depository institutions exercising similar or overlapping powers. That is quite apparent when you realize that a number of financial and nonfinancial businesses have acquired thrifts or have their eyes on thrifts in order to benefit from their essentially bank-like powers to gain access to Federal deposit insurance and participate in the payments mechanism.

In considering this matter, we have suggested before, and I repeat again, that you might develop the concept of a qualified thrift, and that is reflected in the bills both you and Senator Proxmire have proposed, Mr. Chairman. The concept is to exclude those thrifts from parallel coverage of the Bank Holding Company Act if they really do specialize in residential mortgage credit. That is the reason presumably public policy has given special privileges and protections to these institutions in the first place. If that public policy concern continues, it should be reflected in a heavy commitment in residential mortgage lending, and we believe with a heavy commitment in residential mortgage lending it would be consistent with the overall approach that we are proposing that they retain their status as unitary thrifts and the privileges that go along with that.

In that connection, we would make some changes in the present law for unitary thrifts. The Home Loan Bank Board has proposed that they do not combine with underwriters of corporate debt and equity. We certainly would agree with that and that change in the law should be made whether or not the thrift meets the qualifying assets test.

As to the question of what the test should be, we feel that the test should be the simple, direct one of how much is in residential mortgage assets or mortgage-backed securities. We would include one to four family and multifamily dwelling mortgages, mortgage-backed securities, mobile home loans, loans for home improvement, and participation interests in such instruments and that kind of mortgages or assets. We don't really believe it's necessary that we go beyond that simple, direct, positive definition.

In your proposed language, Mr. Chairman, you provide an alternative test of no more than 25 percent commercial loans. If you had such a test at that level, there are a great many commercial banks that would qualify as qualified thrifts. Since the public policy issue at stake here is real estate lending and, more specifically, mortgage lending, and they should be held to that test, we think an appropriate test would be 65 percent of their assets in that kind of instrument; about 75 percent of all S&L's today would meet that test.

I would point out, in terms of their own operations over time, with the increasing use and popularity of variable rate mortgages and adjustable rate mortgages, they can participate in these activities now without exposing themselves to the kind of interest rate risk that was true in the past.

In proposing that test we recognize that some S&L's and a good many mutual savings banks can't meet that test given their traditional asset competition and it's particularly a problem with the mutual savings banks where they have had substantial investments in corporate bonds. We would propose handling that problem by providing a relatively long phase-in period, say 5 to 10 years, beginning where they are but with some specified milestones that they would have to meet over time to retain the temporary qualification as a qualified thrift; and then, ultimately, we would expect them to reach the full test.

The only other important problem that I'm aware of in this area is the difficulties of the mutual institutions, as many S&L's and mutual savings banks are, to exercise the powers that would be provided to other S&L's and to commercial banks through affiliates of a common holding company. We believe that there needs to be some work in providing a mutual institution, particularly if it doesn't qualify as a qualified thrift, with the same privileges in terms of powers that a commercial bank holding company would have.

As far as bank holding company procedures are concerned—and I will be very brief in that section because I think it is perhaps the least controversial section—the bills before the committee provide for a substantial streamlining. The regulatory process would work more rapidly and with less burden of proof on the part of the institution involved to showing a positive net public benefit. The presumption would be that an extension of activities within the limitations of the antitrust law and the other limitations of the bill would itself be taken as a prima facie case that they can move into those areas. Procedures would be less cumbersome in terms of the possibilities of present procedures of competitors delaying the process in order to protect their own competitive position.

In terms of any rulemaking, there would still be the necessity for and adequate procedures for hearings and deliberations before general rules were put in place.

NEW ACTIVITIES RAISE QUESTIONS OF SAFETY AND SOUNDNESS

As far as new activities are concerned, as I indicated, I do believe this is the most controversial area and we take them up one by one after making one general distinction. Some of these new activities, I think, raise questions of safety and soundness and those, of course, are of particular concern to us and require careful consideration. Others, looking at the testimony before the committee, seem mainly to involve questions of conflicts of interest, tying, and the like. Those problems are important, but they're a different set of problems than we are concerned with when we look at the safety and stability of the bank itself, which is an important continuing concern of ours.

Looking at these one by one and taking securities activities first, the proposed legislation would permit commercial banks to underwrite municipal revenue bonds and mortgage-backed securities and sponsor and distribute mutual funds. The Board believes that, in general, these activities do involve a manageable degree of risk for banking organizations and there is a potential for competitive gain.

Upon examining the hearing record and after our own further consideration, we would raise some questions for your consideration more specifically. These are responsive to the concerns that have been raised in the hearings. At the same time, we approach some of those concerns with a good deal of care. We have not supported, and it is not proposed in these bills, that bank or bank holding company affiliate underwriting of corporate securities be permitted. We think that's a major area where conflicts of interest and safety and soundness issues arise. But the issue doesn't arise in these bills because the bills would not permit it. All the bills, by putting these things in separate subsidiaries, have a number of provisions specifically designed to promote competitive equity and to limit risks to affiliated banks. They have to be conducted in a separate holding company affiliate. The affiliate must be separately capitalized in a manner comparable to similar firms not affiliated with the holding company. They would all come under the present restrictions of section 23(a) of the Federal Reserve Act and section 23(b) permitting limited intercompany transactions and loans and defining the terms of those intracorporate transactions. You already have some fundamental protections against conflicts of interest and for regulatory treatment.

A number of witnesses have suggested further protections such as using a different name for the securities affiliates, requiring that the officers and employees of the affiliate or investment company be separate from those that operate an affiliated bank, that information on the financial activities of the bank's customers not be made available to the securities affiliate and vice versa. An additional suggestion is that, the banks might be prohibited from guaranteeing or providing letters of credit to support obligations that another arm of the holding company is underwriting through its securities affiliate.

It seems to us that those kinds of proposals could be looked at very carefully to see if they are necessary to strengthen the protections that are already in the bill.

Similarly, some of those kinds of proposals could be adapted to the mutual fund or investment company activities of affiliates of bank holding companies.

One further point I would raise in this connection, as you know, we have permitted, through a separate affiliate, banks to engage in so-called discount brokerage. Basically, that involves passive order taking for securities and equity securities traded in the stock markets. We believe that is permitted under the present Bank Holding Company Act but it is being challenged in the courts now and we would suggest it would be useful to put a specific provision in the law making clear that this is permitted and, at the same time, raise the question for your consideration as to whether it is appropriate to go beyond that and provide for a bank affiliate to provide a full range of brokerage services, including investment advice, at the same time that it is able to conduct the actual transaction on a brokerage basis. That does seem to us to raise additional questions of conflict of interest and even safety and soundness over time and is something you might want to focus on specifically as to whether you want to go that far.

As far as the underwriting of mortgage bonds is concerned, we recognize that here you are getting into, I suppose, a conceptually different area and that we are talking about private securities. Banks can already underwrite mortgage bonds backed by Government agencies or Government-sponsored agencies. What is at issue here is whether they can be permitted to underwrite private securities.

We believe that there could be useful results from this extension of the authority of a bank holding company, but that the authorities should be confined to mortgages backed by one to four family mortgages without getting into the area of corporate financing through large commercial-type mortgages. Confining it to one to four family mortgages would also deal with risk problems as well as potential conflict of interest problems. We also believe it would be reasonable to say, as in the case of municipal revenue bonds, that if a bank affiliate is doing the underwriting, a sister of that affiliate should not engage in guaranteeing or providing a letter of credit to support the bond, to support the mortgage pool, that underlies the securities underwritten by the securities affiliates. And we would suggest that you examine those possible modifications to deal with some of the issues that have been raised, and with that examination and consideration, we, of course, continue to support bank activities in these areas.

In the area of real estate brokerage, I do not think there are substantial problems of risk, particularly if the tying problem is taken care of. Your bill, Mr. Chairman, already provides a number of protections against conflicts of interest and tying.

We raise essentially one additional issue here that you might want to consider. There has been particular concern that whatever provisions are put in the legislation there will be a suspicion or an actuality that somebody dealing with a real estate brokerage affiliate of a bank holding company is going to get favorable treatment from the bank itself when it comes to making a mortgage and, of course, the mortgage transaction is an extremely important financial transaction for the average and even the wealthy American.

It seems to us you might look at the possibility of actually excluding the bank itself from making a mortgage to a person that has dealt with an affiliate of that bank in a real estate brokerage affiliate. That is the portion of the holding company that has special Federal protections. That is the portion of the affiliate that can take advantage, for instance, of insured deposits. We would not at all suggest that such a limitation apply to other areas of the bank holding company, in particular any mortgage banking subsidiary. Other real estate brokerage firms are attached or have access to mortgage banking companies and other banks, so the limitation that we would suggest that you look at would be confined to the bank itself. Even there, problems might arise in the case of smaller banks that don't have mortgage banking facilities or in areas of the country where alternative sources of credit are not so readily available, and we suggest you might want to look at the precedent that has already been created in the insurance brokerage field for smaller banks or banks in areas of the country without a lot of competition in providing mortgage finance.

Those are suggestions in that area to deal with some of the questions that have arisen in earlier testimony you have heard.

RISKS INVOLVED WITH REAL ESTATE DEVELOPMENT

We have before expressed a good deal of concern about the risks involved in bank holding companies getting into real estate development and our observation of what has happened in the past year or so since this proposal was made does not reduce our concern in this area at all. As you know, in the savings and loan area, this is now permitted and a number of States are broadening the ability of banks to participate in this area.

It is our understanding that the great bulk of the banks interested in this area are not interested in conducting a full range of activities that might be implied by real estate development. That is a very vague term and its broadest definition involves a whole range of entrepreneurial activity and even speculative activity in acquiring and developing land and building and all the rest.

We would suggest to you that the scope of real estate development be narrowed to passive equity participation in projects or developments essentially managed by others and by at least providing the Federal Reserve with authority to limit bank loans to projects sponsored by affiliates of a bank holding company, perhaps by requiring that outside lenders also be involved so that you get a third-party judgment on the credit risks.

We believe with these changes the objections that have been raised very forcefully by some of the testimony before you, some of which parallels our concerns, some of which goes beyond our concerns in the area of conflict of interest, could be dealt with, and with the limitations already proposed this activity could go forward.

In the area of insurance brokerage and underwriting, some of the same issues as in the brokerage area arise. We do not believe given the nature of the insurance brokerage business and the widespread forms that that can take that it is possible or desirable to examine the question that I did suggest for real estate brokers; that is, the bank itself couldn't lend. There are problems here that would be so crippling if we said that a bank couldn't lend to any customer that it was dealing with on the insurance side that I think that is essentially unworkable. We would rely more on the kinds of protections that you have already incorporated in your legislation, Mr. Chairman, and we also would suggest that it's not necessarily an all-or-nothing question, that there are possibilities for phasing in certain activities. Indeed, there are already precedents in the law, as you well know, for that.

As far as underwriting is concerned, where questions of both concentration of resources and risks arise, we have supported that activity. We recognize that underwriting is already heavily regulated by the States. You have proposed yourself some proposals to try to deal with the concentration of resources question, Mr. Chairman. In looking at the particular test that you have proposed, we question whether it achieves the purposes that you have in mind and raise again two questions.

If this is a matter of concern, if that is what is holding up consideration of this, then I think a more straightforward limitation encouraging entry on a de novo or relatively limited basis by bank holding companies into the underwriting business could be considered and, of course, that would presumably work the other way too; if an insurance company were going into the banking business, it would do it de novo or with limited entry.

Alternatively, or conceivably in addition, some aspects of the insurance business where banks have particular familiarity could be broken off and a phase-in done by permitting entry, for instance, into title insurance or relieving some of the restrictions on their ability now to provide credit-related insurance. We believe that movement should be made in this area.

We propose these elements for consideration not because we believe that they are necessarily essential to the bill, but to try to throw out some ideas for dealing with questions that have been raised by others.

ACTIVITIES OF STATE-CHARTERED BANKS

The statement goes on to deal with the question of activities of State-chartered banks. Let me just read that part of my statement on page 28. Much concern has been expressed about possible authorizations to State-chartered banks of new authorities to conduct nonbanking businesses that would not be permitted to bank holding companies under present or new Federal laws. It is reasonable to ask the question whether it makes any sense for the Congress to work out carefully balanced arrangements for the conduct of nonbanking activities of bank holding companies only to see far different and inconsistent arrangements established for State banks under State law.

Some States have adopted, and others are considering, legislation to authorize State-chartered banks to engage in insurance, securities, and real estate development activities; and others have authorized State-chartered thrifts to engage in virtually unlimited activities. Last year, South Dakota authorized State-chartered banks to engage in insurance-related activities essentially in all of the States of the Union except South Dakota. The States are motivated in part by a desire to make their financial institutions competitive with those in other States and in part by a desire to obtain new employment and revenues—inevitably at the expense of others. As the process gains momentum, more and more States will feel themselves forced, in self-defense, to take similar steps. The threat is obvious—any sense of congressional or Federal control over the evolution of the banking and financial system will be lost.

S. 2181 attempts to deal with this problem by requiring that insurance activities be conducted in the State and outside the State on the same terms. S. 2134 would go considerably further by requiring that States may only authorize activities for State-chartered banks to be conducted within the State and for residents of that State.

In the light of current developments, it now appears desirable to go somewhat further than the provisions of S. 2134, while still maintaining flexibility for State experimentation and innovation. In balancing these considerations, perhaps it is desirable to distinguish between those activities that Congress may decide to prohibit or limit for banking organizations because of safety and soundness problems, and those that arise from conflicts of interest that are particularly important for the protection of local customers.

For example, if Congress reaffirms its decision to exclude banking organizations from participating in underwriting corporate debt and equity, and limits the participation of these organizations in real estate development, it would not seem to be desirable for the States to have the authority to overrule the judgment of Congress and expose the insured depository system to the greater risks of these activities. On the other hand, if Congress decides not to authorize real estate or insurance brokerage because of reasons of consumer protection and competitive equity, it would not seem inconsistent to us with the Federal interests if State legislatures authorize banking organizations to participate in these activities within the confines of their own State. Here the State may be in the best position to make the judgment about what is necessary to protect local customers and local interests.

Thus, the balance between Federal and State interest could be struck as follows: States may not authorize activities that Congress has ruled out of bounds for safety and soundness reasons; the States may optionally authorize other activities but only if they are conducted within their borders.

I won't deal with all the titles of S. 2181 now. We will provide an appendix to the comments on many of those provisions. I would like to say a word about title X which provides specific authority for a 5-year period for States to authorize regional interstate banking acquisitions. Such legislation would presumably resolve the question of the constitutionality of regional arrangements that have been authorized in New England and have been proposed in a number of other areas of the country. Yesterday, the Board of Governors approved two bank holding company mergers under the reciprocal arrangements of Massachusetts and Connecticut. Although there is a strong argument that these State laws are not consistent with the prohibitions against discriminatory burdens on interstate commerce established by the commerce clause of the Constitution, there is an absence of clear and unequivocal evidence to that effect, and that is the test that we apply in acting upon those applications. Consequently, the Board proceeded on the assumption of constitutionally and applied the criterias of the Bank Holding Company Act. But plainly, the differing constitutional interpretations raised by parties to merger applications demonstrates the need for congressional action to clarify this issue at this time.

We believe this is all the more important because of our concern about the permanent establishment of regional banking areas. I think it's fair to say that many members of the Board of Governors approved that application reluctantly on policy grounds. We were making a legal decision within the context of present law. If Congress should decide to endorse regional arrangements, in our view it would be desirable to limit them to a transitional period. We would also urge you to consider the interstate banking question more broadly at an early date, once the powers issues are settled.

In conclusion, Mr. Chairman, I would emphasize that the time for action is here. There is an urgent need for definitive congressional action. In a very real sense, decisions cannot and will not be postponed, whatever you do. The failure to act only means that others have acted and will continue to act to markedly restructure the financial system without the participation of the Congress. These actions, arising out of market initiatives, State legislation, court decisions and new Federal regulatory rules, are pushing at and going beyond the outer boundaries of the legal framework established by Congress for the banking and financial systems. In my judgment, they are certainly pushing beyond the basic policies established by the Congress in setting out a broad distinction between banking and commerce and other aspects of the Bank Holding Company Act in the first place.

NEW ACTIVITIES ARE UNDERMINING PRESENT LAWS

These concerns are not at all theoretical. The policies of the Bank Holding Company Act against excessive risk, conflicts of interest, impartiality in the credit-granting process, and concentration of resources have long been considered essential parts of our financial system. They are clearly being undermined by a haphazard pattern of interindustry and interstate acquisitions and by new combinations of banking, securities, insurance, and commercial products.

The Bank Holding Company and Glass-Steagall Acts were intended to prevent combinations of firms that underwrite securities and take deposits. Yet today there are 32 securities firms that own so-called nonbank banks which can perform many of the essential functions of banks. Court and regulatory decisions are opening new avenues for bank holding companies to undertake securities functions without clear legislative guidance.

The Bank Holding Company Act was intended to prevent combinations of commercial or industrial firms from owning banks, yet today there are retailers, diversified industrial-commercial conglomerates, and insurance firms that own either nonbank banks or thrifts with banking powers.

The States are rapidly considering and adopting legislation granting State-chartered banks powers that, in some cases, have not even been contemplated under Federal law for banks and bank holding companies, in large part reflecting interstate competition for jobs and tax revenue rather than any judgment of the national interest in a stable banking structure.

The Federal financial regulators are also pressing against the outer boundaries of their delegated authority. The Board has adopted the broadest definition of the term bank it felt feasible under existing law in an effort to carry out what it believes to be congressional intent and to preserve the ability of Congress to act without being faced with a fait accompli. That action is being challenged in the courts with, thus far, unfavorable results. The SEC has before it a proposal to consider banks as broker-dealers when they engage in discount brokerage, despite the exclusion of banks from the securities laws because of the comprehensive system of bank regulation. Under existing law, the FDIC is considering the question of whether State nonmember banks should be authorized by regulation to underwrite corporate debt and equity, despite long-presumed congressional intent to separate commercial banking and corporate underwriting. The Comptroller has before it a well known proposal to authorize a family of nonbank national banks in 25 States. We have been compelled to approve the establishment by a New York bank holding company of a nonbank bank in Florida, which would take demand deposits but not make commercial loans as we have broadly defined them.

As things now stand, many of these specific issues will be decided on a case-by-case basis in the courts—but we cannot expect those decisions to be guided by a policy perspective on how the financial system as a whole should evolve. That, in the end, is the task of the legislature, not of the courts, which must struggle to adapt today's circumstances to yesterday's laws. Until all of us—the regulators, the banks, other competing industries, and the courts—have more congressional guidance, every new decision will be subject to legal challenge.

If Congress does not decide, decisions will still be made, as I said, but they seem certain to be conflicting, and not to fit into a coherent whole. One clear risk is that the overriding public interest in a strong, stable, and competitive financial system will be lost.

Thank you, Mr. Chairman.

[The complete statement follows:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve Sytem

I am pleased to come before you as one of the concluding witnesses in what has been a thorough and searching examination of proposals to restructure the law governing bank and thrift holding company activities. These hearings are a culmination of a long process of evaluation of legislative proposals to simplify regulatory procedures and to assure a competitive environment for the provision of financial services.

Hearings on various bills of this kind began in the fall of 1981. Since then this Committee has held 44 days of hearings, heard more than 235 witnesses, and has before it over 7,000 pages of testimony. This extensive record -- including analysis of historical problems, present difficulties, and future solutions -- provides a solid foundation on which to build legislative decisions at this session of Congress.

I have on several occasions emphasized to this Committee the basic framework within which we in the Federal Reserve approach these questions. We want to see a competitive and innovative banking and financial system, providing economical and efficient services to consumers. At the same time, we believe that banks, and depository institutions generally, perform a unique and critical role in the financial system and the economy -- as operators of the payments system, as custodians of the bulk of liquid savings, as unbiased suppliers of short-term credit, and as the link between monetary policy and the economy. This unique role implies continued governmental concerns about the stability and impartiality of these institution -- concerns that are reflected in the federal "safety net" long provided by the discount window and deposit insurance, by regulatory protection against undue risk, and by policies to discourage conflicts of interest and undue concentration of banking resources. As a corollary to these concerns, and as a result of our practical experience in regulating bank holding companies, we also believe that these basic policies must, to a degree, apply to the holding companies of which banks and other depository institutions are a part; banking institutions cannot be wholly separated from the fortunes of their affiliates and from the success or failure of their business objectives.

A review of the testimony before this Committee indicates that these principles are broadly accepted. Progress has been made toward achieving some convergence of views on the definitions of a bank and thrift institution, on the scope of regulatory authority, and on possible simplification of regulatory approaches toward bank holding companies.

In my testimony in January in Salt Lake City, I suggested new legislation is urgently needed dealing with several areas:

(a) a strengthened definition of bank;

(b) a definition of a qualified thrift;

(c) new procedures to streamline application of the bank and thrift holding company Acts;

(d) the powers of depository institutions holding companies; and

(e) statutory guidelines to govern the division of state and federal authority in the area of banking organization powers.

There are a growing number of issues about interstate banking that soon will need to be dealt with as well, but, with one exception, those questions could be deferred to later legislation. The exception concerns Congressional policy toward the present movement toward regional interstate banking arrangements.

Our analysis of the bills and much of the testimony that have been placed before this Committee indicate elements of agreement in several of the necessary areas. There appears to be an emerging consensus on defining what is a bank -- a fundamental building block for any legislation to clarify the role of banks and bank holding companies within our financial and economic system. New procedures for applying the Bank Holding Company Act and simplifying regulation seem to be broadly accepted. Some convergence on the appropriate role of thrift institutions and their holding companies may be developing, as well as on the need to rewrite guidelines for state-federal relationships. Equally clearly, substantial differences in defining the appropriate range of powers for bank holding companies remain apparent.

It seems to me the time has come to consolidate areas of agreement, to consider objections to the proposals before the Committee, and to test alternative approaches to bridging the remaining differences. Today, I would like to share with you our further thinking on the five key problem areas and, in particular, address some possible solutions to the remaining problems.

I. Definition of Bank

The definition of "bank" is a crucial provision of the Bank Holding Company Act. It defines those institutions which are covered by the Act, and for them the boundaries for the safeguards against excessive risk, conflicts of interest and concentration of resources deemed appropriate as a matter of public policy. The application of these policies depends upon a meaningful definition that encompasses all depository institutions that perform essential banking functions.

Marketplace, technological, and regulatory developments have seriously undermined the present definition, which defines a bank as an institution which accepts demand deposits and makes commercial loans. Functional evasion of the purpose of the Act is becoming the rule rather than the rare exception through the creation of "nonbank banks" and other devices that permit combinations of banking activity and commercial, retail, insurance and securities firms. As a result, established policies on conflicts of interest and concentration of resources are undercut or jeopardized. These same techniques are being used to undermine the Congressional prohibition on interstate banking. The haphazard exploitation of "loopholes" in existing law is reflected in an understandable sense of competitive unfairness and could, in time, jeopardize the safety and soundness of the banking and payments system. The developments are broad in scope, as reflected in the tabulation in Appendix A.

To deal with this situation, last year we suggested a re-definition of the term "bank" to include any depository institution (other than a FSLIC insured institution) that is (a) FDIC insured, (b) eligible for FDIC insurance, or (c) which takes transaction accounts and makes commercial loans. This definition was included in the FIDA legislation and was adopted in Senator Proxmire's bill (S. 2134) and a number of bills introduced in the House.

Our review of this proposal in the light of comments made at the hearing suggests consideration should be given to three changes. First, industrial banks that are not federally insured and do not offer deposit accounts with checking or other third party transaction capabilities should be excluded. Appendix B describes these institutions and the scope of their activities.

Second, state-chartered thrift institutions (also described in Appendix B), which are not federally insured and which would have been covered by the definition of bank described above, should be encompassed within the same holding company rules as federally insured S&Ls because of the focus of many of these state institutions on home lending. These institutions could be exempted from coverage by the Bank Holding Company Act if the relevant state regulator certified their activities were appropriately confined.

Third, the nonfederally insured thrifts and industrial banks that would be excluded from the coverage of the Bank Holding Company Act should be subject to rules which would prevent "tandem" operation -- that is, joint sale of banking or thrift products or integrated operations -- of these institutions with owners engaged in impermissible activities for bank holding companies. This limitation, on which we place considerable importance, is explained in detail in Appendix C. Its basic objective is to prevent the kinds of tying that are judged to be unfair or unsound for depository institutions, including joint offering of deposit products or loans with other products of affiliated industrial and commercial firms.

We believe that Congress should not exempt the so-called "consumer bank" from the definition of a bank. Such a proposal is contained in Section 104 of S. 2181, which would allow a "consumer bank" to take all forms of deposits, including transaction accounts, and make consumer loans, as well as a wide variety of other types of credit extensions, including some commercial loans.

Such an approach would permit commercial and industrial firms to enter into essential depository institution activities, including access to the payments system, in a manner that would inevitably undermine public policy objectives incorporated in the Bank Holding Company Act generally, and there would be the appearance of unfair competition with banks subject to the Act. In such circumstances, the regulated banking sector would inevitably wither and much of the banking business would take place in institutions not subject to the policy restrictions on risk, conflicts of interest, and concentration of resources. The lengthening list of nonbank bank acquisitions demonstrates that we are beginning to see that migration today. In this connection, I would point out that 19% of commercial banks now have commercial loan portfolios (narrowly defined) equal to not more than 5% of assets and that 47% have 10% or less of their assets in this form. Thus, almost half of the number of commercial banks in this country, could, with some minor restructuring of their portfolios, conduct basically the same activities as they do today and escape application of the policies of the Bank Holding Company Act.

Finally, I believe competitive equality requires that the recent and current proliferation of nonbank banks not be blessed by grandfather provisions, subject to a reasonable period of time to permit divestiture where this is necessary.

II. Definition of Qualified Thrift

Essentially the same problems of consistency with the public policy objectives of the Bank Holding Company Act arise when commercial and industrial firms acquire thrift institutions, particularly in the light of the broader powers provided such institutions in recent legislation. Indeed some state initiatives have provided state-chartered thrifts essentially the full panoply of banking powers and more. At the same time, there may be institutions with no restrictions on the activities of the parent firm, an ability to obtain long-term government-sponsored credit, favorable tax treatment, and a freedom to branch intrastate and interstate -- privileges that are denied commercial banks. As in the case of nonbank banks, there has been increasingly clear recognition of the need to adopt rules to assure equality of treatment of various kinds of depository institutions exercising similar or overlapping powers. The need for action is reflected in the strong interest of a variety of financial and nonfinancial businesses in the acquisition of thrifts in order to benefit from thrifts' bank-like powers, to gain access to federal deposit insurance, and to participate in the payments mechanism.

The Administration proposals attempt to deal with this question by requiring all thrifts, with certain exceptions for grandfathered service corporations, to meet the requirements of bank holding companies. This approach has been opposed mainly on the grounds that it is not necessary to apply the same rules applicable to bank holding companies to those thrifts that concentrate their assets in home mortgages. In an attempt to recognize these concerns, the concept of a "qualified thrift" has been developed, reflected in the proposals of both Senators Garn and Proxmire, to exclude thrifts truly specializing in residential mortgage credit from comparable rules to those limiting the scope of activities of bank holding companies.

We would support this general approach. Thrifts that meet an adequate "specialization" test rooted in the public policy concern of support for residential mortgage lending could be owned by commercial or industrial firms as unitary thrifts are now.

In developing the specifics of such an approach, we would endorse the recommendation of the FHLBB that an underwriter of corporate debt and equity not be permitted to own a thrift, whether or not it meets the qualifying assets test. We would also rely upon a single direct test of the proportion of assets held in residential mortgages or mortgage-backed securities. An optional test of limited commercial lending, such as not more than 25% of its assets in certain qualifying commercial loans, as proposed in S. 2181, would leave open the clear possibility that institutions not engaged substantially in home mortgage lending would retain the liberal treatment with respect to permissible activities now accorded to unitary S&Ls. For example, with such a test, 75% of all commercial banks today could be treated as thrifts because they have less than 25% of their assets in qualifying commercial loans; only six commercial banks would qualify under the 60% of assets in residential mortgages part of the dual test of S. 2181.

We believe an appropriate test would require that to be eligible for unitary savings and loan holding company treatment, institutions must devote at least 65% of their assets to residential mortgages or mortgage-backed securities. For this purpose, mortgages would include both 1-4 family and multi-family dwelling mortgages, mortgage-backed securities, mobile home loans, loans for home improvements, including participation interests in such instruments. Based on this definition, according to our calculations, almost three-fourths of FSLIC institutions would currently meet this test. We also believe the limits on commercial lending set in the Garn-St Germain Act remain appropriate for federally chartered institutions, and in the light of the much wider powers provided by some states for commercial lending, a supplementary (not optional) limit on commercial lending could be considered for eligibility of these state-chartered institutions.

We recognize some S&Ls and mutual savings banks that could not meet the qualified thrift test currently, but still wish to emphasize home lending and who wish to retain the privilege of "unitary" S&L treatment, should be permitted a substantial period in which to conform their activities. During this transition period, which could be five to ten years, milestones should be set in terms of measuring progress toward achieving the required asset composition. While ownership by an industrial or commercial firm could be retained during the transition period and thereafter, we do not believe such thrifts should be permitted to operate in "tandem" with the parent commercial or industrial firms. (The details of this suggestion are outlined in the form of legislative language in Appendix D. The description of the limitations on tandem operations is, as noted above, contained in Appendix C.)

In general, under this approach, those thrifts (and their service corporations) not meeting the asset test (or in transition toward them) would generally have to conform to the limitations on ownership of, and powers provided to, bank holding companies generally. Special tax benefits and the access to long-term credit from the Home Loan Banks for these nonqualifying institutions should be reviewed. At the same time, methods should be developed to permit mutual institutions to take advantage of powers permitted bank or thrift holding companies in stock form.

III. Bank Holding Company Procedures

The third core element of legislation is the provisions on bank holding company procedures. S. 2181,

S. 2134, and FIDA contain essentially identical provisions on this point and I believe that this reflects widespread support for procedural simplification.

These provisions make improvements in two major areas: they change the present somewhat complex applications process into a notice procedure; and they put bank holding companies on more equal footing with their competitors by changing the "benefits vs. adverse effects" test and formal hearings requirements. Instead, new activities could go forward, after notice to the Federal Reserve Board, unless the Board found grounds for disapproval under specific statutory criteria. Those statutory tests include adequacy of financial and managerial resources, protection of impartiality in the provision of credit and avoidance of adverse effects on bank safety and soundness.

The thrust of these provisions, and a provision reducing the scope for judicial review by competitors, is intended to reduce the burden placed upon bank holding companies by government regulation to a minimum level consistent with protection of the public policy interests embodied in the specified criteria. Agency procedures would not be burdened by formal hearings and judicial review at the instance of competitors. Formal rulemaking procedures would, of course, remain necessary before decisions to add new activities to the list of permissible holding company powers, and the Board could continue to request public comment on notices and hold informal hearings, where necessary, to obtain information necessary to make decisions.

We also believe the new procedures set out in S. 2181, S. 2134 and FIDA provide the Board with adequate supervisory authority over the activities of the holding company and its nonbank subsidiaries after they are in operation. Those procedures would emphasize the desirability of relying upon other regulatory agencies, such as the Commodity Futures Trading Commission in the area of commodity brokerage and the SEC in the case of securities activities, for supervisory and reporting requirements in order to avoid unnecessary duplication of effort. However, the statute provides adequate authority to take whatever regulatory or data gathering steps that may be necessary to ensure compliance with the Bank Holding Company Act.

My conclusion is that these provisions adequately balance the need for reducing unnecessary regulatory burdens with the requirements for adequate supervision to enforce fully the provisions of the Bank Holding Company Act. These provisions seem to me ready for inclusion in legislation.

IV. New Activities of Bank Holding Companies

The fourth element of needed legislation is expanded powers for holding companies. S. 2181 provides new authority for holding companies to: (a) sponsor and distribute mutual funds and underwrite and distribute revenue bonds and mortgage-backed securities (b) engage in real estate brokerage and development, (c) provide insurance brokerage and underwriting, (d) own a thrift institution, and (e) take part in other services of a financial nature.

Considerations of competitive equality and potential benefits to consumers of a broader range of suppliers of financial services strongly suggest a presumption broadening the range of powers permitted bank holding companies. The point is reinforced by technological developments that enhance the options in the delivery of such services. However, as I stressed at the outset, those objectives must be balanced against other public policy concerns: assurance of fair and open competition in the provision of credit and other services, maintenance of impartiality of banks in credit judgments, and avoidance of practices that can undermine the strength of the bank itself. Balancing these objectives is surely the most difficult task before you.

Certain of the proposed activities, including those involving essentially "agency" activities, such as real estate and insurance brokerage, raise few questions of safety and soundness. In certain other areas, such as real estate development, much more significant risks to the holding company, and potentially to the bank itself, arise. Questions about conflicts of interest and tying for a number of the activities have been discussed in detail by the witnesses that have preceded me in recent weeks.

Review of comments made during these hearings and other information has suggested a number of areas in which the Committee might bridge differences by modifying or limiting earlier proposals. In particular, we have attempted to address carefully the safety and soundness and the competitive fairness considerations that appear to stand in the way of broad agreement on a substantial broadening of bank holding company powers. In my testimony today I would like to review each of the categories of proposed new activities in light of those considerations.

(a) Securities Activities - Underwriting Municipal Revenue Bonds and Mortgage-backed Securities, and Sponsoring and Distributing Mutual Funds

Both S. 2181 and S. 2134 would authorize bank holding companies to underwrite municipal revenue bonds and similar instruments and to sponsor and distribute mutual funds. The Board supports both of these activities, based on a considerable period of experience with bank underwriting of general obligation bonds and managing trust assets. The Board believes that these activities involve a manageable degree of risk for banking organizations and there is potential for substantial gain for customers in terms of a variety of services and lower costs.

At the same time, bank performance of these services has been opposed because of several concerns. One line of concern suggests that the provision of credit by a bank affiliate, or guarantees of underwritten obligations by bank affiliates, would provide a distinct advantage to bank affiliated underwriters, or that temptations to link underwriting and loan business would be strong, to the potential detriment of the bank or its customers. It is alleged that investment flows might be influenced by the bank's interests, or that poor investment or underwriting performance by a holding company affiliate might reflect adversely on the bank itself.

We approach these arguments with some care taking account of the fact that bank underwriting of corporate securities is not proposed and of the rather successful coexistence of bank affiliated and independent underwriters of municipal general obligation bonds. Moreover, S. 2181 and S. 2134 already contain a number of provisions specifically designed to promote competitive equity and limit risk to affiliated banks.

Those bills already require that all securities activities of the holding company, including its subsidiary banks, be conducted in a separate holding company affiliate. The affiliate must be separately capitalized in a manner comparable to similar firms not affiliated with a bank holding company. The present rules contained in section 23A of the Federal Reserve Act and the proposed new section 23B would limit intercompany transactions and require that they be on market terms. All these provisions provide fundamental protections against conflicts of interest and unequal tax and regulatory treatment.

Nevertheless, a cautious approach in this area is justified and a number of suggestions proposed by others to assure competitive equity and avoid conflicts deserve attention. Thus, it may be reasonable to prohibit a bank holding company's securities or investment company affiliate from using the name of an affiliated bank or bank holding company (in the interest of appropriate disclosure, an indication of company affiliation should be permissible). It may also be desirable to require that the officers and employees of a securities affiliate or investment company advisor be separate from those that operate an affiliated bank, and that information on the financial activities of the bank's customers not be made available to the securities affiliate and vice versa. Banks might be prohibited from guaranteeing or providing letters of credit to support obligations that are underwritten by a securities affiliate.

So far as mutual funds are concerned, the existing provisions of the Investment Company Act, together with the applicable suggestions above, appear generally adequate to assure independent investment judgment. However, those provisions could be reviewed to determine if any other special provisions are necessary to assure independence from the bank affiliate.

I have noted in earlier testimony a trend toward conglomerates of financial services, and toward the explicit or implicit tying of various financial products by financial conglomerates not including banks. To assure competitive equality, I believe that restrictions of the kind I have described above, if adopted, would need to be accompanied by provisions giving the Board certain discretion in their application should nonbank conglomerates develop combinations of services prohibited bank holding companies.

Questions have also arisen over bank holding company participation in brokerage services. The Federal Reserve, as you know, has permitted "discount" brokerage -- that is, the passive provision of brokerage services without investment advice -- under present law. Because that ruling is under court challenge, we believe it should be explicitly provided for in the proposed legislation. You may wish to review, however, the further question of the appropriateness of combining such services with investment advice -- that is, providing a full range of brokerage services -- within the framework of a bank holding company.

The mortgage market is being transformed by innovations in communications technology and in marketing techniques. Banking organizations are major mortgage lenders and are familiar with the credit analysis and have other expertise necessary to establish mortgage pools and evaluate the underlying risks of the constituent elements in the pool. They can already underwrite mortgage bonds guaranteed by the government or sold by government-related agencies.

What is at issue here is whether a bank affiliate should be permitted to underwrite private securities. Should the authority be confined to securities backed by 1-4 family mortgages, potential risks would be substantially defused. Risks and conflicts of interest in bank holding company participation in underwriting in those circumstances would appear to be manageable within the confines of the anti-tying rules already contained in present law and in S. 2181. As in other areas, however, questions of competitive equity have been raised, particularly in view of the ability of depository institution holding companies to provide, through their subsidiary banks, guarantees or letters of credit to support mortgage pools established and underwritten by securities affiliates. The appropriateness of combining those two aspects of financing services could be re-examined.

In summary, we believe adequate techniques are available to satisfy legitimate concerns about bank holding company activity in the securities area, so long as corporate security underwriting remains prohibited. The potential benefits to competition and in terms of reducing underwriting costs, in these circumstances, point to action along the lines proposed by the Administration, and by Senators Garn and Proxmire.

(b) Real Estate Brokerage and Development

As I suggested earlier, the main issue in providing authority for bank holding companies to engage in real estate brokerage is not risk but potential conflicts of interest and problems of competitive equity. It has been suggested that the ability of a bank holding company real estate broker to offer assured bank financing, or even the impression that such assured financing is available because of the ownership tie between affiliated broker and bank lender, could be sufficient to divert business away from the independent and toward the bank or thrift affiliated broker.

As with the case of securities affiliates, limitations on the holding company broker using the same name as the holding company or its subsidiary bank, strengthening the already strict rules against explicit or implicit tying, and enhancing enforcement through providing a private right of action, could provide considerable protection against abuse. Possibly, a further step could be taken by prohibiting any mortgage loans by a subsidiary bank or thrift of a depository holding company to any customer of an affiliated real estate brokerage firm.

It should not be necessary -- nor would it seem fair -- to limit loans by a holding company mortgage banking subsidiary to the customers of the affiliated broker. Nondepository firms are today permitted to combine ownership of brokerage and mortgage banking subsidiaries. Of course, appropriate supervisory steps would and could be taken to prevent reciprocal lending arrangements or other steps to evade this limitation.

Smaller banks, without mortgage banking subsidiaries, might be put in a difficult competitive position by such a limitation. Consequently, such an approach might be accompanied by an exemption for smaller banks, reasonably related to a relative unavailability of competing brokerage services. It should be possible, for instance, to draw an analogy to provisions of Title VI of the Garn-St Germain Depository Institutions Act of 1982, which permits bank holding companies to offer insurance brokerage services where they would otherwise be impermissible if their consolidated assets were $50 million or less, or in towns of under 5,000, provided a brokerage affiliate is required to permit or encourage a home purchaser to explore other possible sources of credit.

Technology is providing both independent brokers and those now associated with financial and retail conglomerates with almost instant access to an array of providers of mortgage credit, enabling their customers to compare terms and conditions. In these circumstances, real estate brokerage appears to be an area in which bank holding companies can draw on relevant experience, undertake little additional risk (particularly if tie-ins are avoided), and increase competitive outlets.

In my past appearances before this Committee, I have expressed serious concern about the potential risks and conflicts for bank holding companies under the general rubric of "real estate development." Those concerns remain.

Present proposals deal with those risks by limiting the capital a bank holding company could apply to real estate development activities or by prohibiting construction activity -- limitations which should be reinforced by also limiting the leverage of the real estate development subsidiary. I would go further by urging you to consider: (a) confining "real estate development" to passive equity participation in projects or developments managed by others, and (b) limiting bank loans to projects sponsored by affiliates of a bank holding company.

The first change would be consistent with what we understand to be the basic objective of most bank holding companies in the real estate development area -- to participate in the potential benefits accruing only to equity participants in a real estate project. To achieve this goal, the rather broad scope of the authorization for real estate development activities contained in FIDA or S. 2181 could well be narrower; for example, participation could be confined to investment vehicles such as nonvoting common stock, preferred stock, or limited partnership interests.

Some of those testifying have expressed concern about the competitive and risk implications of a bank, as lender, participating in a project in which an affiliate has an equity interest. They suggest that a bank in those circumstances will be more willing to extend credit and to carry a weaker credit longer to one of its "own" projects, and perhaps be less willing to extend credit to competing projects, than if no equity interest is involved. To deal with this situation, it might be useful to provide the Board with clear discretionary authority to impose an aggregate or particular limitation on loans by a bank to projects in which a bank real estate affiliate is an equity participant.

(c) Insurance Brokerage and Underwriting

Insurance brokerage by bank holding companies, as is the case with real estate brokerage, does not involve major issues of risk; rather the focus of the testimony has been on assuring competitive equity between bank affiliated brokers and independent distributors of insurance products. Thrift institutions already have unlimited authority to engage in insurance brokerage, and the broadening of this activity for bank holding companies should provide competitive benefits so long as abuse of the bank relationship is avoided.

S. 2181, in Section 107, contains a number of new provisions that attempt to reduce tying and competitive inequity problems. It would, for example, require banks to inform their customers of the availability of insurance products elsewhere, allow customers purchasing insurance products from bank holding subsidiaries an adequate opportunity to reject their contracts, and prohibit banks and their holding companies from offering insurance until the customer is given a commitment that credit will be extended. It does not seem practically feasible to go much further in this area without destroying completely the ability of holding company organizations to participate in this activity. We would, however, suggest that to the extent Congress deems these provisions necessary when financial institutions sell insurance, they should also be applied to thrift institutions and their holding companies, which are permitted to broker insurance without restrictions such as contained in Title VI of the Garn-St Germain Act.

Consideration could also be given to possible approaches for phasing in greater bank participation in the insurance brokerage area. Again, it might be useful to build upon Title VI of the Garn-St Germain Act, which permits bank holding company participation in insurance brokerage activities in cases where the holding company's consolidated assets are $50 million or less, in towns of 5,000 or less, or otherwise where the holding company demonstrates that existing insurance agency facilities are inadequate. For instance, those limitations might be gradually increased by some amount over time up to a limit, which would provide an occasion for further Congressional review.

If bank holding companies are permitted to engage in underwriting, careful attention will have to be given to containing risk, avoiding concentration of resources and more subtle conflicts of interest. For example, there may be particular lines of insurance underwriting that raise issues of risk that require special safeguards and limitations on such matters as amount of capital investment. Moreover, I have earlier suggested that banks not be permitted to lend to companies in which their holding company affiliates had very substantial equity interests.

In order to limit the potential for concentration of resources associated with large bank holding companies acquiring large insurance firms or vice versa, S. 2181 would limit bank holding company investment in nonbanking activities to not more than 25% of the holding company's capital if the holding company's consolidated assets amount to more than 0.3% of total domestic deposits. However, our review of the data indicates that this test does not effectively limit the ability of some of the largest bank holding companies to acquire control of some of the largest insurance companies.

I recognize that our attempt to devise a numerical test of that kind must be arbitrary at the margin. However, an alternative approach could be to provide specific criteria on the size of bank holding company participation in insurance underwriting and insurance underwriter participation in banking. This could be done by requiring that bank holding companies enter insurance underwriting de novo or through relatively small acquisitions. Similarly, insurance underwriters would also be confined to de novo or foothold acquisition of banks. This approach would deal with the concentration issues and it would provide time for the participants, the Board, and state insurance regulators to gain experience in dealing with combined insurance and banking entities.

An alternative approach would be to expand bank holding company participation in insurance underwriting in directions that flow naturally from existing bank functions. For example, it would seem appropriate for bank holding companies to participate in insuring or guaranteeing the credit risk in home mortgages and in real estate title insurance. Dollar limits on individual credit-related property and casualty insurance policies underwritten by bank holding company nonbank affiliates could be lifted. After some experience, Congress could then consider other areas of insurance underwriting activity that might be appropriate as part of a gradual evolution of bank holding company insurance underwriting.

(d) Ownership of Thrifts

S. 2181 specifically permits bank holding companies to acquire FSLIC insured thrifts, subject to the same kind of limitations on interstate acquisitions as are written in the Douglas Amendment and the same kind of branching restrictions on the acquired thrift as are contained in the McFadden Act. The Board has supported bank holding company acquisition of thrift institutions as a reasonable extension of their presently authorized scope of activities. We recognize, however, that acquisition of thrifts by bank holding companies on an interstate basis may, in some situations, not be fully consistent with the prohibition on interstate banking contained in the Douglas Amendment. The Board has indicated its views that Congress should, in the future, address the overall question of interstate banking in comprehensive legislation. However, pending Congressional action on the overall question, the Board believes it is reasonable to incorporate Douglas and McFadden type limitations on thrift acquisitions that are proposed in S. 2181.

(e) Financial Services

S. 2181 authorizes holding companies to engage in "services of a financial nature." This provision provides useful flexibility for the Board to deal with uncertain and unknown circumstances in the future. We recommend its inclusion in legislation.

The decision of Congress on the inclusion or exclusion of the various activities that have been discussed above will provide some guidance on the intended scope of this provision. Additional guidance would be desirable with respect to other activities that the Congress might consider to be within the scope of this authorization.

V. Activities of State-Chartered Banks

Much concern has been expressed about possible authorizations to state-chartered banks of new authorities to conduct nonbanking businesses that would not be permitted to bank holding companies under present or new federal laws. It is reasonable to ask the question whether it makes sense for the Congress to work out carefully balanced arrangements for the conduct of nonbanking activities of bank holding companies only to see far different and inconsistent arrangements established for state banks under state law.

Some states have adopted, and others are considering, legislation to authorize state-chartered banks to engage in insurance, securities, and real estate development activities; and others have authorized state-chartered thrifts to engage in virtually unlimited activities. Last year, South Dakota authorized state-chartered banks to engage in insurance-related activities essentially in all of the states of the Union except South Dakota. The states are motivated in part by a desire to make their financial institutions competitive with those in other states and in part by a desire to obtain new employment and revenues -- inevitably at the expense of others. As the process gains momentum, more and more states will feel themselves forced, in self-defense, to take similar steps. The threat is obvious -- any sense of Congressional or federal control over the evolution of the banking and financial system will be lost.

S. 2181 attempts to deal with this problem by requiring that insurance activities be conducted in the state and outside the state on the same terms. S. 2134 would go considerably further by requiring that states may only authorize activities for state-chartered banks to be conducted within the state and for residents of that state.

In the light of current developments, it now appears desirable to go somewhat further than the provisions of S. 2134, while still maintaining flexibility for state experimentation and innovation. In balancing these considerations, perhaps it is desirable to distinguish between those activities that Congress may decide to prohibit or limit for banking organizations because of safety and soundness problems, and those that arise from conflicts of interest that are particularly important for the protection of local customers.

For example, if Congress reaffirms its decision to exclude banking organizations from participating in underwriting corporate debt and equity, and limits the participation of these organizations in real estate development, it would not seem to be desirable for the states to have the authority to overrule the judgment of Congress and expose the insured depository system to the greater risks of these activities. On the other hand, if Congress decides not to authorize real estate or insurance brokerage because of reasons of consumer protection and competitive equity, it would not seem inconsistent with the federal interests if state legislatures authorize banking organizations to participate in these activities within the confines of their own state. Here the state may be in the best position to make the judgment about what is necessary to protect local customers and local interests.

Thus, the balance between federal and state interest could be struck as follows: states may not authorize activities that Congress has ruled out of bounds for safety and soundness reasons; the states may optionally authorize other activities but only if they are conducted within their borders. We would be prepared to assist the Committee in drafting such a provision.

Other Provisions of S. 2181

My comments today have focused only on Title I of S. 2181 as I believe it is that Title that requires the priority attention of the Congress. Detailed comments on a number of other Titles are contained in Appendices to be submitted separately for the record. Before my concluding remarks, I would like to comment specifically on the provisions contained in Title X on regional interstate banking.

Title X provides specific authority, for a five-year period, for states to authorize regional interstate banking acquisitions. Such legislation would presumably resolve the question of the constitutionality of regional arrangements that have been authorized in New England and have been proposed in a number of other areas of the country. Yesterday, the Board approved two bank holding company mergers under the reciprocal arrangements of Massachusetts and Connecticut. Although there is a strong argument that these state laws are not consistent with the prohibitions against discriminatory burdens on interstate commerce established by the Commerce Clause of the Constitution, there is an absence of clear and unequivocal evidence to that effect. Consequently, the Board proceeded on the assumption of constitutionality and applied the criteria of the Bank Holding Company Act. But plainly, the differing constitutional interpretations raised by parties to merger applications demonstrates the need for Congressional action to clarify this issue at this time.

We believe this is all the more important because of our concern about the permanent establishment of regional banking areas. If Congress should decide to endorse regional arrangements, in our view it would be desirable to limit them to a transitional period. We would also urge you to consider the interstate banking question more broadly at an early date, once the powers issues are settled.

Conclusion

I cannot emphasize strongly enough the urgent need for definitive Congressional action on the legislation now before you during the current session. Decisions cannot be postponed -- the failure to act only means that others have acted and will continue to act, to markedly restructure the financial system without the participation of the Congress. These actions, arising out of market initiatives, state legislation, court decisions and new federal regulatory rules, are pushing at the outer boundaries of the legal framework established by Congress for the banking and financial systems. In my judgment, they are pushing beyond the basic policies established by the Congress in setting out a broad distinction between banking and commerce.

I am not speaking about theoretical concerns. The policies of the Bank Holding Company Act against excessive risk, conflicts of interest, impartiality in the credit-granting process, and concentration of resources have long been considered essential parts of our financial system. They are now being undermined by a haphazard pattern of inter-industry and interstate acquisitions and by new combinations of banking, securities, insurance and commercial products.

The Bank Holding Company and Glass-Steagall Acts were intended to prevent combinations of firms that underwrite securities and take deposits. Yet today there are 32 securities firms that own so-called nonbank banks which can perform many of the essential functions of banks. Court and regulatory decisions are opening new avenues for bank holding companies to undertake securities functions without clear legislative guidance.

The Bank Holding Company Act was intended to prevent combinations of commercial or industrial firms from owning banks, yet today there are retailers, diversified industrial-commercial conglomerates, and insurance firms that own either nonbank banks or thrifts with banking powers.

The states are rapidly considering and adopting legislation granting state-chartered banks powers that, in some cases, have not even been contemplated under federal law for banks and bank holding companies, in large part reflecting inter-state competition for jobs and tax revenue rather than any judgment of the national interest in a stable banking structure.

The federal financial regulators are also pressing against the outer boundaries of their delegated authority. The Board has adopted the broadest definition of the term bank it felt feasible under existing law in an effort to carry out what it believes to be Congressional intent and to preserve the ability of Congress to act without being faced with a _fait accompli_. That action is being challenged in the courts with, thus far, unfavorable results. The SEC has before it a proposal to consider banks as broker-dealers when they engage in discount brokerage, despite the exclusion of banks from the securities laws because of the comprehensive system of bank regulation. Under existing law, the FDIC is considering the question of whether state non-member banks should be authorized by regulation to underwrite corporate debt and equity, despite long-presumed Congressional intent to separate commercial banking and corporate underwriting. The Comptroller has before it a well-known proposal to authorize a family of "nonbank" national banks in 25 states. We have been compelled to approve the establishment by a New York bank holding company of a nonbank bank in Florida, which would take demand deposits but not make commercial loans as we have broadly defined them.

As things now stand, many of these specific issues will be decided on a case-by-case basis in the courts -- but we cannot expect those decisions to be guided by a policy perspective on how the financial system as a whole should evolve. That, in the end, is the task of the legislature, not of the courts which must struggle to adapt today's circumstances to yesterday's laws. Until all of us -- the regulators, the banks, other competing industries, and the courts -- have more Congressional guidance, every new decision will be subject to legal challenge.

If Congress does not decide, decisions will still be made. But they seem certain to be conflicting, and not fit into a coherent whole. One clear risk is that the overriding public interest in a strong, stable, and competitive financial system will be lost.

The time for action is here. Many elements of comprehensive legislation are already broadly accepted. I believe the remaining elements and the necessary compromises can be put together soon. I hope and believe this Committee can be the vehicle for moving ahead.

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APPENDIX A

OWNERSHIP OF NONBANK BANKS

1. Securities firms (32). Most of the nonbank banks are owned by securities firms. At least 32 securities firms own nonbank banks, including major firms such as E.F. Hutton, Prudential-Bache, Shearson/American Express, Merrill Lynch, Fidelity Management & Research Co., Marsh & McLennan, Drexel Burnham Lambert, and J. & W. Seligman. Although some of these nonbank banks are state chartered trust companies that do not accept demand deposits and that have been organized to perform trust services to the parent organization, a number of other nonbank banks owned by securities firms do engage in demand deposit taking and consumer lending (*e.g.*, Dreyfus Consumer Bank).

2. Diversified financial and industrial conglomerates (6). A number of companies engaged in diversified commercial and industrial activities also have acquired nonbank banks, including Gulf & Western Industries (movies, commercial finance, etc.), Avco Corp. (manufacturing of aircraft engines, electronics, thrift and finance companies), Control Data Corp. (data processing, finance companies), Chrysler Corp. (automobile manufacture), Parker Pen Company (manufacturing, insurance, and thrift companies), and Automated Data Processing (data processing).

3. Other financial services organizations (9). Nonbank banks also have been acquired by organizations that offer a wide range of financial services, such as Household Finance Corporation and Beneficial Corporation, and Bradford National Corp. and some bank holding companies, such as Citizens Fidelity, Comerica, and U.S. Trust Corporation. Norwalk Savings Bank, Anchor Savings Bank, Greater Providence Deposit Corporation, and Teachers Service Corporation also own nonbank banks.

4. Insurance companies (3). Several insurance companies have acquired nonbank banks, including Prudential, Travelers, and Mutual Benefit Life Insurance Co. Aetna has withdrawn its application to acquire a nonbank bank.

5. Retail companies (3). Retail companies also have acquired nonbank banks, including McMahan Valley Stores, and J.C. Penney Company.

NONBANK BANKS*

	Bank	Parent Company	Acquired/ Formed
CALIFORNIA			
1.	American Pacific Natl. Bank & Trust Co., Newport Beach	American Pacific Corp., Irvine, California	application denied
2.	Associates National Bank, Concord	Gulf & Western Corp., New York, New York	1980
3.	Avco National Bank, Anaheim	Avco Corp., Greenwich, Connecticut	1982
4.	Capital Guardian Trust Co., Los Angeles	The Capital Group Inc., Los Angeles, California	1968
5.	Pacific Securities Depository Trust Co., San Francisco	Pacific Coast Stock Exchange, San Francisco, California	1974
6.	Security Trust Co., Los Angeles	Bradford National Corp., New York, New York	1981
7.	Trust Services of America Inc., Los Angeles	Calif. Federal Savings & Loan Association, Los Angeles, California	1982
8.	Valley National Bank of Salinas	Household International, Prospect Heights, Illinois	1981
9.	Western Family Bank N.A., Carlsbad	McMahan Valley Stores, Carlsbad, California	1982
COLORADO			
10.	Resources Trust Co., Englewood	Integrated Resources Inc., New York, New York	1983
CONNECTICUT			
11.	Citizens National Bank, Fairfield	Norwalk Savings Bank, Norwalk, Connecticut	1983

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* In addition, Dimension Financial Corporation has filed applications to charter 31 national banks in 25 states.

Bank	Parent Company	Acquired/ Formed
DELAWARE		
12. Beneficial National Bank (USA), Wilmington	Beneficial Corp., Wilmington, Delaware	1983
13. Colonial National Bank, Wilmington	Teachers Service Organization, Willow Grove, Pennsylvania	1982
14. Delaware Charter Guarantee & Trust Co., Wilmington	Corporation Service Co., Wilmington, Delaware	1977
15. First National Bank of Wilmington	Commercial Credit Corp., Baltimore, Maryland	1983
16. E.F. Hutton Trust Co., Wilmington	E.F. Hutton Group Inc., New York, New York	1983
17. E.F. Hutton Bank, Wilmington	E.F. Hutton Group Inc., New York, New York	1983
18. First National Bank of Harrington, Harrington	J.C. Penney Company, Inc., New York, New York	1983
FLORIDA		
19. Templeton Management & Trust Co. N.A., Ft. Lauderdale	Principals of the Templeton Group of mutual funds, Nassau, Bahamas	1983
20. U.S. Trust Company of Florida, N.A. Palm Beach	U.S. Trust Corporation New York, New York	1984
GEORGIA		
21. Capital City Bank, Hapeville	Prudential-Bache Securities Inc., New York, New York	1983
ILLINOIS		
22. Chicago Title & Trust Co., Chicago	Lincoln National Corp., Fort Wayne, Indiana	1979
23. Midwest Securities Trust Co., Chicago	Midwest Stock Exchange, Chicago, Illinois	1973
24. Washington National Trust Co., Evanston	Washington National Corp.	1975

Bank	Parent Company	Acquired/ Formed
MARYLAND		
25. T. Rowe Price Trust Co., Baltimore	T. Rowe Price & Associates Inc., Baltimore, Maryland	
MASSACHUSETTS		
26. Boston Safe Deposit & Trust Co.	Shearson/American Express Inc., New York, New York	1981
27. Investors Bank & Trust Co., Boston	Eaton & Howard, Vance Sanders Inc., Boston, Massachusetts	1969
28. Fidelity Management Trust Co., Boston	Fidelity Management & Research Co., Boston, Massachusetts	1981
29. Marsh & McLennan Trust Co., Boston	Marsh & McLennan Inc., New York, New York	1983
30. Massachusetts Co., Boston	Travelers Corp., Hartford, Connecticut	1969
31. Trust Management Bank, Boston	Rollert & Sullivan Inc., Boston, Massachusetts	1983
32. Wellington Trust Co. of Boston NA	Wellington Management Co./Thorndike, Doran, Paine & Lewis, Boston, Massachusetts	1982
MICHIGAN		
33. Automotive Financial Services, Inc., Highland Park	Chrysler Corp., Inc. Detroit, Michigan	1981
MINNESOTA		
34. IDS Trust Co., Minneapolis	Investors Diversified Services Inc., Minneapolis, Minnesota;	1979

Bank	Parent Company	Acquired/ Formed
MISSOURI		
35. Investors Fiduciary Trust Co., Kansas City	DST Inc., Kansas City, Missouri	1972
NEW HAMPSHIRE		
36. Fidelity Bank & Trust Co., Salem	Fidelity Management & Research Corp., Boston, Massachusetts	1983
37. First Deposit National Bank, Tilton	Parker Pen Co., Janesville, Wisconsin	1981
NEW JERSEY		
38. City Trust Services N.A., Elizabeth	City Federal Savings & Loan Assn., Elizabeth, New Jersey	1975
39. Drexel Trust Co., Paramus	Drexel Burnham Lambert Group Inc., New York, New York	1983
40. Dreyfus Consumer Bank, East Orange	Dreyfus Corp., New York, New York	1983
41. Merrill Lynch Bank & Trust Co., Plainsboro Township	Merrill Lynch & Co. Inc., New York, New York	1984
NEW YORK		
42. Bradford Trust Co., New York	Bradford National Corp., New York, New York	1972
43. Brown Brothers Harriman Trust Co., New York	Brown Brothers, Harriman & Co., New York, New York	
44. National Trust Company, White Plains	Automated Data Processing, Inc.	1983
45. Depository Trust Co. of New York, New York	New York Stock Exchange and other users	1973
46. Dreyfus National Bank & Trust Co., New York	Dreyfus Corp., New York, New York	1983

Bank	Parent Company	Acquired/ Formed
47. Fidelity National Bank & Trust Co., New York	Fidelity Management & Research Corp., Boston, Massachusetts	1984
48. Savings Bank Trust Co., New York	Mutual savings banks of New York State	1933
49. J. & W. Seligman Trust Co., New York	J. & W. Seligman & Co., New York, New York	1982
NORTH CAROLINA		
50. Manning & Napier Trust Co. Inc.	Manning & Napier Advisors Inc., New York, New York	
OHIO		
51. The Ohio Co. trust department, Columbus	The Ohio Co., Columbus, Ohio	1976
52. Citizens Fidelity (Ohio), N.A., Cincinnati	Citizens Fidelity Corporation, Louisville, Kentucky	1983
53. Comerica Bank-Midwest, N.A., Toledo	Comerica, Incorporated Detroit, Michigan	1983
OREGON		
54. Columbia Trust Co., Portland	Columbia Management Co., Portland, Oregon	1980
PENNSYLVANIA		
55. Philadelphia Depository Trust Co., Philadelphia	Philadelphia Stock Exchange	1979
56. Vanguard Fiduciary Trust Co., Valley Forge	Vanguard Group of Investment Cos., Valley Forge, Pennsylvania	1982

Bank	Parent Company	Acquired/ Formed
RHODE ISLAND		
57. Mutual Benefit Trust Co., Providence	Mutual Benefit Life Insurance Co., Newark, New Jersey	1983
58. Great Providence Trust Co., Providence	Greater Providence Deposit Corporation, Providence, Rhode Island	1971
UTAH		
59. American Investment Bank N.A., Salt Lake City	Leucadia National Corp., New York, New York	1983
WASHINGTON		
60. Frank Russell Trust Co., Tacoma	Frank Russell Co. Inc., Tacoma, Washington	1980
61. Savings Bank Trust Co. Northwest, Seattle	Shearson/American Express Inc., New York, New York	1970

APPENDIX B

ACTIVITIES OF INDUSTRIAL BANKS AND PRIVATELY INSURED SAVINGS AND LOAN ASSOCIATIONS

A. Industrial Banks

Historically, industrial banks (also referred to as Morris Plan banks or industrial loan companies) were consumer-oriented institutions that engaged in extending installment credit to consumers and that accepted savings deposits or sold investment certificates, which are similar to certificates of deposit. They were called industrial banks because they served industrial workers who in the early part of this century often could not obtain credit from commercial banks. Industrial banks traditionally did not accept checking accounts of any type. Although some industrial banks appear to have had the power to make commercial loans, this authority was not widely exercised.1/

Since approximately 1980, however, the activities of industrial banks have expanded substantially, and these institutions today offer a wide range of financial services,

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1/ General background information regarding industrial banks may be found in H. Jennings, The Consumer in Commercial Banking (1939); R. Saulnier, Industrial Banking Companies and Their Credit Practices (1940) and Amend the Bank Holding Company Act of 1956; Hearings on S.2353, S.2418, and H.R. 7371 before a Subcomm. of the Senate Comm. on Banking and Currency, 89th Cong. 2d. Sess. 155 (1966).

which make them essentially indistinguishable from commercial banks. As Table I shows, there are approximately 1,200 industrial banks located in 21 states.[2/] Substantially all of these institutions are now permitted to make commercial loans. Ten states have authorized their industrial banks to offer NOW accounts, and approximately 95 industrial banks in those states have commenced offering such accounts.

Nine states provide some sort of insurance for funds deposited in industrial banks.[3/] The FDIC has ruled that industrial banks in Colorado, Hawaii, Nebraska, Tennessee and Utah are eligible for FDIC insurance. Industrial banks in a number of other states appear to be eligible for FDIC insurance as a result of the Garn-St Germain Depository Institutions Act of 1982, but the FDIC has not taken a position regarding those states. Under the Garn-St Germain Act, institutions that are eligible for FDIC insurance include

> any bank, banking association, trust company, savings bank, industrial bank or similar financial institution which the board of directors [of the FDIC] finds to be operating substantially in the same manner as an industrial bank . . . .

12 U.S.C. § 1813.

[2/] Three additional states authorize industrial banks but have no institutions operating.

[3/] California, Colorado, Hawaii, Iowa, Kansas, Minnesota, Nebraska, Rhode Island, and Utah.

A few institutions in Florida, North Carolina and West Virginia secured FDIC insurance prior to the Garn-St Germain Act, but the FDIC has not decided whether other institutions in those states are eligible for insurance. Industrial banks located in California, Florida and Iowa presently have applications for insurance pending with the FDIC. Four states require their industrial banks to secure FDIC insurance if they wish to accept deposits (or in some instances if they wish to offer NOW accounts).[4] Industrial banks that are eligible for FDIC insurance are also subject to reserve requirements and have access to the Federal Reserve's discount window.[5]

In summary, industrial banks have full commercial lending powers and are able to fund their commercial loans with checking accounts and savings accounts that may be insured by the FDIC. They also have access to the Federal Reserve System in its role as lender of last resort for the banking system. The NOW accounts offered by industrial banks are checking accounts that perform the same function as demand deposits, that are advertised as checking accounts, and for the majority of consumers are the equivalent of a conventional demand checking deposit.[6] The significant expansion of the powers of industrial banks that has occurred since 1980 and their eligibility for FDIC insurance has rendered them institutions capable of frustrating the purposes of the Bank Holding Company Act.

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[4] Florida, Hawaii, Tennessee and West Virginia.

[5] 12 U.S.C. § 461.

Indeed, the potential that industrial banks have to function as commercial banks has prompted a number of the largest bank holding companies in the country to acquire industrial banks and approximately 50 such acquisitions have occurred since 1980, when industrial banks first gained NOW account powers. This rate of acquisitions is more than double that which occurred in the period of 1971-1979. A number of these industrial banks have obtained FDIC insurance.

B. State Chartered, Privately Insured S&Ls

State chartered, privately insured savings and loan associations exist in five states.[7] As Table II shows, there are approximately 394 such institutions, which control some $16 billion in deposits.[8] All of these institutions are authorized to make commercial loans and accept NOW accounts and many may accept demand deposits. The great majority of these institutions are mutual associations and thus raise no issues under the Bank Holding Company Act or the Savings and Loan Holding Company Act.

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[6] Unlike the traditional passbook or savings account, withdrawals from NOW accounts may be made by checks given directly to third parties. Although technically subject to the right of the depository institution to require the depositor to provide advance notice of withdrawal, this right is never invoked with respect to NOW accounts. Indeed, because invocation of the notice by the depository institution would require the dishonoring of checks given by the depositor to third parties for value, the technical notice requirement cannot as a practical matter be imposed with respect to NOW accounts.

[7] Maryland, Massachusetts, North Carolina, Ohio and Pennsylvania.

State chartered, privately insured S&Ls are eligible for FSLIC insurance, but have opted for private insurance instead. Although these S&Ls are sometimes simply referred to as "state insured S&Ls," it is more accurate to describe them as state chartered S&Ls, the deposits of which are privately insured under authority of state law. These S&Ls are primarily engaged in making residential mortgage loans and have the same powers as other state chartered S&Ls in the relevant state. For the most part, such powers are generally comparable to those of federally chartered S&Ls, although in some instances the powers of state chartered S&Ls exceed those of federally chartered institutions.

Many state chartered, privately insured S&Ls are mutual in form, but approximately 30 such institutions have corporate parents. These corporate parents are concentrated in Ohio, Maryland, and North Carolina, and engage in a variety of activities, from simply holding the subsidiary S&L's shares to operating a chain of restaurants. In addition, some of these parent organizations, such as Warner National Corporation and Control Data Corporation, operate on a nationwide basis, and engage in a variety of nonbanking activities such as the computer business.

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[8] If state insured savings banks are included, this amount would be $27.5 billion.

Although state chartered, privately insured S&Ls are currently primarily engaged in home lending, they have the capability to function in the same manner as a commercial bank to the extent that they may make commercial loans and offer NOW accounts. In addition, such institutions qualify as "depository institutions" for purposes of the Monetary Control Act, and therefore have access to the Federal Reserve discount window. Despite these facts, such institutions are not subject to the Savings and Loan Holding Company Act, and may also be able to avoid coverage under the Bank Holding Company Act, particularly if they do not engage in commercial lending. The ability of these institutions to gain access to the payments mechanism and the Federal Reserve discount window therefore presents an anomalous situation in view of the freedom from prudential regulation enjoyed by their corporate parents. Consequently, these institutions should be subjected to the Savings and Loan Holding Company Act, just as other S&Ls.

Industrial Bank Activities By State[1]

State	NOWs Authorized (Date)	No. of Institutions	Est. No. Offering NOWs	Total Deposits (All Types) ($ millions)
Arizona	No	0	0	0
Arkansas	Yes (1980)	3	3	34
California	Yes (1982)	86	8	1900
Colorado[2]	Yes (1980)	154	70	322
Connecticut	Yes (1949)	0	0	0
Florida[3]	Yes (1980)	3	3	32
Hawaii[2][3]	No	69	0	480
Indiana	Yes	5	0	309
Iowa	No	52	0	181
Kansas	No	12	0	9
Kentucky	No	125	0	NA
Maine	No	0	0	0
Minnesota	No	29	0	53
Missouri	No	2	0	10
Nebraska[2]	No	34	0	320
Nevada	No	6	0	175
North Carolina	No	1	0	4
Oklahoma	Yes	9	2	NA
Rhode Island	Yes (1971)	11	5	668
Tennessee[2][3]	No	420	0	NA
Utah[2]	Yes (1980)	54	2	469
Virginia	No	12	0	0
Washington	No	26	0	0
West Virginia[3]	Yes (1980)	92	2	33
TOTALS	Yes=10 No =14	1205	95	4999

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[1] Data as of 12/83. Substantially all industrial banks are permitted to make commercial loans.

[2] Eligible for FDIC insurance. Many other industrial banks appear to be eligible for FDIC insurance as a result of the Garn-St Germain Act, but FDIC has not taken a position regarding them.

[3] FDIC insurance required if deposits are offered. In some instances, this requirement is applicable only if NOW accounts are offered.

Privately Insured S&Ls

State	NOWs Authorized (Date)	No. of Institutions	Total Deposits (All Types) ($ millions)
Maryland	Yes	105	6,000
Massachusetts	Yes (1973)	103 [1]	4,700
No. Carolina	Yes (1981)	43	1,800
Ohio	Yes (1981)	74	3,500
Pennsylvania	Yes (1980)	69 [2]	115
TOTALS	Yes=5	394	16,115

Privately Insured Savings Banks

Massachusetts	Yes	159[3]	11,400

1/ Only 2 of these are stock institutions, and neither of those two has a corporate parent.

2/ Only a few stock institutions exist, and only one of them has a corporate parent.

3/ Some of these institutions are also insured by the FDIC, in which case the Massachusetts fund covers deposits in excess of $100,000.

APPENDIX C

LIMIT ON TANDEM OPERATIONS

The availability of the exemption from the activity restrictions of the Savings and Loan Holding Company Act for unitary savings and loan holding companies of both federally and non federally insured thrift institutions should be limited to those thrift institutions that are engaged primarily in housing lending and that do not operate in tandem with affiliated nonbanking organizations. Without a limitation on tandem operations, many business organizations may feel compelled to become affiliated with a thrift in order to remain competitive, and competition and stability would be increasingly compromised. The growing number of securities, insurance, retail, and manufacturing firms that have already acquired S&Ls or nonbank banks suggests the danger.

To prevent such an occurrence, a variety of relationships falling under the general heading of "tandem operations" should be prohibited for companies that wish to take advantage of the unitary S&L holding company exemption. The major element of this limitation is a prohibition on the mutual offering of products and services. Thus, prohibited tandem operations would encompass the sale or marketing of the S&L's products by nonbanking affiliates and the sale or marketing by the S&L of the products or services offered by those affiliates. For example, the deposits of the S&L

could not be sold or marketed by its nonbank affiliates. Similarly, the S&L could not offer or market the insurance, securities, real estate or retail products of its affiliates. The offering of discounts or incentives by an S&L or its affiliate to encourage a customer to purchase products or services from the other organization is another example of a practice that would be barred.

The tandem operation provision could be implemented in other ways. Consideration might be given to prohibiting the subsidiary S&L of a unitary S&L holding company from operating at the same location with affiliates engaged in nonbanking activities. This would mean, for example, that an S&L could not provide space in its lobby for its nonbanking affiliates, nor could it establish branch offices or RSUs at the locations of offices of those nonbanking affiliates.

Similarly, a subsidiary S&L of a unitary S&L holding company might not be permitted to provide customer referrals for its nonbanking affiliates, nor could those affiliates refer business to the S&L. Thus, a retail affiliate could not rely on the S&L to make loans to the retailer's customers to finance purchases from the retailer; and real estate, insurance or securities affiliates could not refer customers to the affiliated S&L.

APPENDIX D

Amendments to the National Housing Act to Establish a Qualifying Test for the Unitary Savings and Loan Holding Company Exemption (Assuming a Ten Year Phase In.)

Section 408(n) of the National Housing Act (12 U.S.C. 1730a(n)) is amended as follows:

"(n)(1) A savings and loan holding company, the subsidiary insured institution of which devotes less than 65 percent of its assets to residential mortgages and related investments on average during any year, shall not thereafter commence, or continue for more than three years, either directly or indirectly, including through a subsidiary (other than an insured institution), any business activity not permissible for a multiple savings and loan holding company under subsection (c) of this section. For the purposes of this subsection, the term "related investments" means (A) securities backed by residential mortgages; (B) retail mobile home loans; (C) home improvement loans; (D) loans to finance the construction of residential properties; (E) participations in the above loans; and (F) investments in service corporations except that such investments shall be reduced by an amount proportionate to the amount of such corporation's assets that are not residential mortgages or related investments as defined in this subsection. This paragraph shall not apply during the ten year period following the date of enactment of this paragraph to a unitary savings and loan holding company, the subsidiary insured institution of which does not meet the asset composition test established by this paragraph on the date of enactment of this paragraph, provided that the insured institution does not decrease the percentage of its assets devoted to residential mortgages and related investments below the percentage it held on the date of enactment of this paragraph and increases, within the following time periods from the date of enactment of this paragraph, such percentage of its assets devoted to residential mortgages and related investments by an amount at least equal to the following percentages of the difference between 65 percentum and the percentage of its assets devoted to residential mortgages and related investments on the date of enactment of this paragraph:

(i) within two and one-half years, 25 percentum;

(ii) within five years, 50 percentum;

(iii) within seven and one-half years, 75 percentum.*/

"(2) In the event that an insured institution that is owned or controlled by a savings and loan holding company offers or markets the products or services of such savings and loan holding company or of any other subsidiary of such holding company, or the products and services of such insured institution are offered to or marketed through such holding company or any of its other subsidiaries, such savings and loan holding company and all subsidiaries thereof (other than an insured institution) shall not thereafter commence, or continue for more than three years, any activity not permissible for a multiple savings and loan holding company under subsection (c) of this section.[*]

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*/ If a five-year phase-in period were adopted, these transition periods could be reduced.

"(3) For the purpose of determining compliance with the three and ten year periods described in this subsection, the last sentence of paragraph (2) of subsection (c) hereof shall not be applicable."

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[*] These provisions against tandem operations are identical to those in S. 2134, 98th Cong., 1st Sess. (1983), introduced by Senator Proxmire.

Appendix E

Staff Technical Appendix

INTEREST ON DEMAND DEPOSITS AND REQUIRED RESERVE BALANCES

The prohibition against interest on demand deposits has been undermined over the years both in theory and in practice by a number of developments. These developments include (1) implicit interest payments on demand deposits through the provision of customer services without explicit charge or at fees below costs; (2) legislative and regulatory changes to permit explicit interest-bearing transaction accounts for non-business customers that are legally distinct from demand deposits, although functionally the same; and (3) market development of close demand deposit substitutes that earn interest, such as money market mutual funds, and enable demand deposit holders to minimize the volume of funds in their accounts. Since the public's transactions balances to some extent are already earning a return, directly or indirectly, authorizing the payment of interest on demand deposits should not have a substantially adverse impact on the earnings of many depository institutions over the long run, although there is likely to be some adverse impact initially, particularly for smaller and medium-sized institutions.

Title IV would enable the Board to pay interest on reserves held in connection with certain types of accounts. This proposal would help offset the adverse earnings impact of interest-bearing demand deposits and would enhance competitive equity.

Reserve requirements, while imposed for monetary policy purposes, represent a form of tax that falls unevenly across institutions providing comparable services. The application of non-interest bearing reserve requirements reduces the rate that depository institutions can afford to pay on their deposit liabilities relative to those institutions not subject to reserve requirements. Payment of interest on required reserves would remove this competitive distortion.

More specifically, Title IV would require interest to be paid on a limited fraction of required reserves -- those held against money market deposit accounts and Super NOW accounts -- accounts upon which depository institutions now pay market rates of interest. (Most MMDAs -- those not held by businesses -- have no reserve requirement.) Paying interest on reserve balances held against these accounts would remove one cost for depository institutions not borne by money market funds or other providers of a similar service and tend to further equalize competitive opportunities. If payment of interest is permitted for demand deposits, it should logically be accompanied by payment of interest on the reserves held against these deposits. This would help to cushion the impact on the costs of depository institutions of interest on demand deposits.

As rates paid on deposits adjusted upward with the payment of interest on reserves, interpretation of the monetary aggregates, particularly M1, might be complicated by blurring the distinction between accounts that now are used mostly for savings purposes, such as MMDAs, and those, such as Super NOW accounts (and demand deposits if they earn interest), that are transactions oriented and a component of M1. With interest paid on reserve balances, depositors would be able to receive as good a yield on Super NOW accounts (and potentially demand deposits) as on MMDAs (taking into account service charges) and the former would also have the capacity for unlimited transfers by check. On the other hand, interest payments on demand deposits and reserves would reduce incentives for the development of transaction-type deposits outside the depository system and the scope of reserve requirements, and would work to maintain the payments system within the basic framework of regulated depository institutions and the federal "safety net." This would help in the formulation and implementation of monetary policy.

Other things being equal, paying interest on reserve balances generally would involve a drain on Treasury revenues. Payment of interest only on reserves against Super NOW accounts and nonpersonal MMDAs, at present interest rates, is estimated to entail a net revenue loss of $165 million a year initially, and the figure would rise over time as deregulation proceeds and these deposit forms become more important. This might argue for some phase in procedure to hold down the near-term budgetary impact.

In addition, it has been our position for some time that authority should be provided to apply reserve requirements to institutions that are not formally depository institutions (and thus are not covered by the prudential rules applicable to these institutions and their holding companies) but that do offer transaction accounts similar to those offered by banks. As long as these close substitutes for bank deposits are free from reserve requirements, and as long as interest is not paid on reserves, they have a potential competitive advantage relative to bank deposits and, at times, they can complicate the task of conducting monetary policy.

In an environment in which Regulation Q ceilings on deposits have been largely eliminated, such problems may not be as acute as they were in the 1981-82 period. Payment of interest on reserves would, as indicated, remove a remaining source of competitive distortion. At the same time, however, the process of financial innovation could well produce still other instruments which will present new problems. Thus, it would be desirable to incorporate into the bill a provision whereby financial instruments issued by nonbank institutions that have transaction or third-party payment powers would be subject to reserve requirements.

APPENDIX F

STAFF TECHNICAL APPENDIX ON TITLES V-VII and IX

TITLE V - CONSUMER LEASES AND RENTAL PURCHASE AGREEMENTS

The Consumer Lease and Rental-Purchase Agreement would simplify and improve the Consumer Leasing Act (which requires disclosure of the terms and costs of leasing personal property by consumers) by applying the principles used in the simplification effort of Truth in Lending. The bill seeks to reduce the burden on lessors and provide the consumer with the most essential cost information by reducing both the number and complexity of disclosures, segregating the disclosures from the other contract provisions to highlight them, and using cross references to the contract for the less important or more detailed terms.

Although the bill would reduce the burden on lessors, it expands the coverage to include rental-purchase agreements. These agreements usually involve the rental of televisions or other home appliances for a term of one week or one month. The agreement is automatically renewable with each payment and there is no obligation to continue payments. After a stated number of payments the consumer may become the owner of the property. Consumer groups have complained of abuses in the industry and the bill addresses some of these concerns by requiring disclosure about ownership rights and payment amounts. The rental-purchase industry has sought coverage because of the belief that federal legislation could provide uniform treatment of these transactions and avoid having these agreements characterized as "sales" under state law.

The bill is based upon draft legislation presented to the Congress by the Board in April 1983. Although the bill is very similar to the Board draft, there are several differences. The major difference pertains to the definition of rental-purchase agreements. The definition in the bill is broader and would include more transactions than the Board's proposed definition -- specifically, agreements in which the consumer must make a lump sum payment to become the owner of the goods. The disclosure and advertisement provisions for rental-purchase agreements are slightly different to accommodate the broader coverage. In presenting the draft legislation to the Congress, the Board suggested that its draft be a starting place, and it assumed that the additional views of other interested parties would change and improve the draft legislation.

TITLE VI -- FAIR DEPOSIT AVAILABILITY

The Fair Deposit Availability Act is intended to address the problems caused by financial institutions delaying a customer's ability to withdraw funds deposited by check -- often referred to as delayed availability of funds. It would require financial institutions to:

1) Disclose their availability policy to potential customers prior to opening an account and thereafter by including a statement on deposit tickets and automated teller machine envelopes, or providing specific notice at the time a deposit is made as to when the funds will be available for withdrawal;

2) Compute interest on funds deposited by check beginning no later than the date on which they receive provisional credit for the check;

3) Endorse checks in accordance with the American National Standards Institute standard or regulations of the Board; and

4) Notify the institution of first deposit within twenty-four hours after deciding not to pay a check in the amount of $250 or more.

The Board has expressed concern about delayed availability problems and favors advance disclosure of delay policies and operational improvements to reduce these problems. Recently, the Board and other federal financial institution supervisory agencies issued a policy statement asking financial institutions that delay availability to take specific steps to address the difficulties that can be caused by delays. This effort and others hold the prospect that delayed availability difficulties can be alleviated by voluntary efforts, thus avoiding some of the costs that usually accompany legislative and regulatory action.

Certain aspects of the current title bear careful consideration to insure that the solutions proposed do not themselves result in problems. For example, we are unaware of problems resulting from the date institutions use in computing interest. Most institutions apparently begin to compute interest from the date of deposit; adoption of the requirement that institutions compute from the date they receive credit for a deposited check risks this becoming the industry standard to the detriment of many consumers.

With regard to the wire notice requirements, we estimate that well over 200,000 return items are generated by the check collection system each day in the amount of $250 or more, compared with the under 20,000 return items in the amount of $2,500 or more. (The Reserve Bank operating circulars currently require wire notice on return items in the amount of $2,500 or more.) Calling for wire notice on this many items could be very burdensome and costly to financial institutions. Although we have not collected data for the entire Federal Reserve System, the Dallas Reserve Bank, which processes wire notices for all return items in the amount of $2,500 or more as part of an experimental return item project, has estimated its current cost for a wire notice at approximately $1.50 per notice.

The Federal Reserve has supported the concept of a uniform endorsement standard, but has not required that an endorsement standard be followed by institutions depositing checks with the Federal Reserve. It is our understanding that the American National Standards Institute's endorsement standard is supported by some industry groups. The Federal Reserve and many financial institutions would not incur significant costs to adopt the standard since their endorsements do not conflict with the standard, and, at most, it would require an adjustment in the placement of the endorsement. Some institutions, particularly smaller institutions, however, may have to make more substantial changes in their equipment and, as a result, incur substantial costs.

TITLE VII - THE CREDIT DEREGULATION AND AVAILABILITY ACT OF 1983

The usury provisions of the Credit Deregulation and Availability Act broaden the coverage of preemptive actions taken with respect to state usury laws in the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). These comments focus on sections 702 and 703 of Title VII, which would remove state usury ceilings on business, agricultural, and consumer loans, while permitting states to establish their own ceilings by enacting overriding legislation within three years. (The DIDMCA contained a temporary preemption of state law with regard to business and agricultural loans which expired on April 1, 1983. The preemption had authorized lenders to charge a rate up to 5 percent above the Federal Reserve discount rate on business and agricultural loans above $1,000 in those states with ceilings less than that variable limit.) Under S.2181, state ceilings would be removed on business, agricultural, and consumer loans of any size, and no alternative federal usury ceiling would be imposed. In addition, the bill would recognize the binding character of state override actions taken since adoption of the DIDMCA, but before the effective date of Title VII.

The Board has frequently noted that adverse impact that usury laws can have upon the availability of credit in local markets, and has recommended the complete removal of such ceilings -- rather than establishment of different ceilings -- as the most appropriate solution. The Board has expressed a preference, however, for corrective action by the states themselves rather than by federal preemption. In this regard, many states have already acted to reduce the constraining effect of their usury ceilings on credit availability. This factor generally reduces the current need for a national law preempting state usury ceilings on business, agricultural, and consumer loans. The provisions in Title VII that provide the states with a means to reestablish their ceilings are an important minimal preservation of state prerogatives.

The current bill represents a substantial improvement over the DIDMCA approach by refraining from imposing an alternative federal ceiling tied to the discount rate. The Board has previously testified that interest rates are best determined in markets unconstrained by arbitrary rate ceilings of any kind. If ceilings were to be imposed, a variable-rate ceiling is preferable to a fixed-rate usury ceiling; however, the use of the Federal Reserve discount rate is an inappropriate index for a variable interest rate ceiling at either the federal or state level.

Section 703 would authorize the Board to publish official interpretations regarding the coverage of the consumer credit preemption provisions. Should the Congress adopt the provision granting this interpretative authority, it would be helpful to have detailed guidance in the legislative history on the intended scope of the preemption to assist in resolving possible conflicts between state and federal law.

TITLE IX -- FRAUDULENT USE OF CREDIT CARDS AND DEBIT CARDS

The Truth in Lending Act and the Electronic Fund Transfer Act contain certain provisions imposing criminal penalties on theft and fraud involving credit or debit card use. Title IX would broaden and strengthen these provisions. It would, among other things, (1) prohibit the transfer or use of account numbers with unlawful or fraudulent intent; (2) make illegal the possession of five or more stolen or counterfeit cards; (3) allow the aggregation of transactions using more than one card to meet the dollar minimum required for the statute to apply; and (4) impose higher penalties for repeat offenders.

Because of the dramatic growth of fraud losses, and because of the potential impact on consumers, financial institutions, and the payments system, the Board has generally supported legislation to strengthen the statutory prohibitions and close gaps in coverage. Credit card fraud losses have grown at a rapid rate in the last several years. For example, total fraud losses for Visa and Mastercard doubled between 1979 and 1982 -- from around $57 million to close to $115 million. Credit and debit card fraud imposes considerable costs on banks, on other card issuing institutions, and, indirectly, on consumers. Account holders have some protection under the Truth in Lending and Electronic Fund Transfer Acts for unauthorized account access, but they may ultimately bear other costs through higher prices or reduced services.

The **Chairman**. Thank you very much, Mr. Chairman.

At the beginning of your statement that you skipped over, I want to emphasize some of your own testimony and I quote:

> Hearings on various bills of this kind began in the fall of 1981. Since then this committee has held 44 days of hearings, heard more than 235 witnesses and has before it over 7,000 pages of testimony. This extensive record, including analysis of historical problems, present difficulties and future solutions, provides a solid foundation on which to build legislative decision at this session of Congress.

Then in your summary you certainly emphasize the need to act. I want to bring out those two points, at the beginning of your 35 pages of testimony and at the end because I still constantly hear over and over again that we should delay, that for whatever reason—this is an election year or we need careful study of these problems before we make decisions.

Now certainly in the nearly decade that I have been in the Senate, I don't think there has been a more complete evaluation of the problems, 7,000 pages of testimony, 235 witnesses, 44 hearings; and prior to that, when Senator Proxmire was chairman of this committee, most of these issues were kicking around then as well, and he held additional hearings over a number of years.

I just want to make the point very, very strongly that the problems have been cussed and discussed over, and over, and over, and over again. I see no need for an additional 7,000 pages of testimony before Congress comes to grips with some of these problems.

DECISIONS NEED TO BE MADE THIS YEAR

Once again, I want to emphasize my total agreement that we do need to make some decisions, whatever those are. If we decide that banks aren't going to do anything else, that is a decision and there are many of the areas of both of these bills and other bills that have been before us that, again, I may not personally like the decisions that are made and others may not like, but the time for making some decisions and setting some national policies is here. The longer we wait, the more difficult they become, and I would also add to many who proposed a 6-month moratorium last year so that we would have adequate time to make these decisions, 9 months have now passed. I have been ready to make decisions. We have given them time and 3 months more, proving my point, I believe, that moratoriums are simply, in most cases—not all, but in most cases, a reason to delay.

I would hope that we would move ahead this year and make decisions, whatever those decisions may be.

Chairman Volcker, you mentioned that the haphazard exploitation of loopholes in existing law could in time jeopardize the safety and soundness of the banking and payment system. Due to some of the changes that have occurred in the nonbank bank area and the fact that such institutions are insured and subject to supervision by both State and Federal regulatory agencies, how would they jeopardize the banking and payments system?

Mr. **Volcker**. Some of them are and some of them aren't subject to supervision. If they are done by a bank, they are subject to some supervision. If they are done by an institution not defined as a bank, they're not within our jurisdiction; in many cases, there are nonfinancial institutions undertaking those activities, and normal protections of the Bank Holding Company Act are absent.

The CHAIRMAN. You have indicated that nonbank banks be divested if your new definition of a bank is enacted in order to maintain competitive equality among depository institutions.

Would you expand this to all types of depository institutions such as S&L's as well as banks?

Mr. VOLCKER. If you're dealing with this kind of comprehensive legislation, there will only have to be a limited amount of divestiture; for a unitary S&L there would not have to be divestiture, except in some very limited cases, I believe, where there may be combinations with underwriters which would be prohibited.

If one were considering a different type of legislation, which we are not proposing, but if in effect, you didn't go along with the broadened powers for bank holding companies, then I think both the legislative policy that that must reflect as well as simple fairness and equity would require a great deal of divestiture running back over a much longer period than if a comprehensive bill were enacted.

The CHAIRMAN. Well, let me quote another statement on page 7:

> Finally, I believe competitive equality requires that the recent and current proliferation of nonbank banks not be blessed by grandfather provisions, subject to a reasonable period of time to permit divestiture where this is necessary.

Mr. VOLCKER. Right.

The CHAIRMAN. To those who do not want to take action, let's assume that we are not able to do anything this year, then is the solution to go to divestiture? What happens if we can't get together and we can't make decisions?

Mr. VOLCKER. I think if you are not going to act on this, then you must act in another way and try to define bank holding companies; you ought to go back and divest, as a kind of permanent matter, all these exceptions that have built up over the years. I don't think that divestiture problem is important; companies that have just gotten into activities recently are on notice about lack of grandfathering, and I don't think it's a serious problem if you have a broad bill.

The idea of having no bill at all wouldn't permit any grounds for divestiture either, so you at least have to have a bill that reasserted the narrow interpretations. Then I think, yes, you should add to those divestiture provisions.

The CHAIRMAN. Well, when I said no bill, I was referring to no bill in the positive way.

Mr. VOLCKER. No broad bill.

The CHAIRMAN. No broad bill to address these problems rather than say stop we'll go back. The issue of divestiture is certainly one that I do not like to contemplate. A lot of people have put a lot of money into these acquisitions, but I have six pages of institutions that have gotten into nonbank banks and it's a rather extensive list, if we did get into a change in the Bank Holding Company Act definition of a bank without a grandfather provision. So I think again it's a reason to make some decisions in a positive vein this year rather than saying stop the world, we want to get off and go back over several years and require a lot of people to spend a great deal of money who invested a great deal of money.

Mr. VOLCKER. I agree with that.

The CHAIRMAN. Divest in order to get competitive equity.

Mr. VOLCKER. If you go ahead with a positive bill and you have an effective date in your own bill and in the administration bill, then you can stick with that effective date, and it wouldn't require a lot of divestiture going backward in time.

The CHAIRMAN. One of the problems with the way many people approach new banks powers is that they view it as a competitive threat and not as a possible benefit. For example, the Comptroller recently sent me a copy of a study done by Hales & Associates of Chicago on the insurance distribution system in banks, the conclusion of which is that insurance agents are spending too much time and effort in keeping banks out of their business when they should be seeking ways of stopping rapid market gains of direct writers and captive agency insurance companies. (See p. 1248.)

The study suggested that banks could help agents to strengthen their businesses presumably through business sharing arrangements. This also may be true for other businesses.

What is your view of that study on the competitive and economic effects?

Mr. VOLCKER. I have not seen that study, but I am aware that insurance agents are subject to competitive threats from the directions that you mentioned. I'm tempted to say cooperative arrangements with banks will take place in the absence of legislation in the form of facilities on premises and the like to provide certain potential convenience for the customer.

The CHAIRMAN. Switching to another subject, last week we had a great deal of discussion with the regulators—the FDIC, FSLIC, and so on—over brokered deposits. As you very well know, the FDIC and the FSLIC have adopted a regulation effective in October to limit brokered deposits. They modified the rule proposed to permit certain brokered deposits to remain insured 2 years beyond the effective date.

THREAT OF BROKERED DEPOSITS ON INSURANCE FUNDS

What is your view of the brokered deposits as a threat to the insurance funds and do you have any recommendations on—if you do feel it is a threat to those funds—how we solve the problem?

Mr. VOLCKER. I believe there have been very clear abuses in this area. It's a threat to the funds. It's a threat to the stability of the banking system more generally, so I support the actions that were taken by those agencies.

We have indicated that we think there are more preferable approaches, but those require legislation; the preferable approach might be to permit some use of brokered deposits by banks, strictly limited in relation to their assets. That limitation might be expressed in relation to their capital; it might be expressed as a percentage limitation, such as 5 percent. I believe it should be low. I believe, however, to have that kind of approach it's necessary to have legislation, because it's not clear that the banking authorities, including ourselves, have adequate legal power to enforce such a limitation without a very cumbersome and problematical showing of direct threat to the safety and soundness of individual institutions, which would be difficult.

If you would like to add to this bill or pass separately a provision providing explicit authority to the regulatory agencies to improve a regulatory restriction at a low level, I believe that would be preferable. But in the absence of that legislation, I believe the steps taken by the FDIC and the FSLIC are appropriate.

The CHAIRMAN. Do you think it's the best they can do at this time and that it requires legislation?

Mr. VOLCKER. I think there is a very real problem.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Chairman Volcker and Chairman Garn, both, I think have emphasized something that I think we should recognize, and that is the absolutely urgency of getting a bill enacted this year. I'm delighted to read what you have given us and hear what you've told us this morning, Chairman Volcker, when you say until the regulators, the banks, other competing industries, and the courts—have more congressional guidance, every new decision will be subject to legal challenge. Then you go on to say that one clear risk is that the overriding public interest in a strong, stable, competitive financial system will be lost.

That's a pretty dire warning and the chairman of this committee has made it clear he takes that very, very seriously, and I know he does, and he's certainly documented this. You've documented in spades the enormous amount of time devoted to this issue. I can't recall any bill before any committee in the 27 years I've been here which has had this kind of study in advance—235 witnesses, 7,000 pages, 44 days of hearings. Obviously, we've done the lathering and now it's time to get out the razor and shave off the beard. I'm very, very happy to hear that.

There's no question in my mind that this committee is going to meet and mark up a bill and report it to the floor and act on it. The question is whether or not we can get action out of the House. I think Chairman St Germain is very interested too and he's moving along on a somewhat different path, but I hope and pray that the House and Senate can get together. This is a tough year. It's not an ordinary year by any means. We have very little time left and the urgency that you stress is exactly what we need. So I want to thank you for that and I think it's a real contribution.

Now the Federal Reserve announced that it's entered into an understanding whereby out-of-State bank holding companies have withdrawn their applications to acquire a State-chartered bank in South Dakota. Some have argued that because of this withdrawal there is less urgency for Congress to address the South Dakota loophole this year. You read to us out of your text at the bottom of page 30 and the top of page 31:

> States may not authorize activities that Congress has ruled out of bounds for safety and soundness reasons; the States may optionally authorize other activities but only if they are conducted within their borders.

That seems to be a very firm and emphatic answer. I take it that you feel that we should act on this even though the South Dakota situation may not be——

Mr. VOLCKER. That South Dakota answer is, so to speak, a holding action and it could be challenged at any time. We have, again, a very difficult gray legal area in that case. And we are passing well beyond the South Dakota situation, which almost has quotation marks around it these days. Other States are acting in these areas and they are acting without all the disabilities of the South Dakota legislation, which had this peculiarity of encouraging the bank subsidiaries to do it out of State but not in State. Some States are going ahead and saying do it anyway. They have already gone ahead, either with S&L's or with banks in some areas, and a number of other States have this under consideration. There is not much doubt in my mind that if Congress does not act in this area the initiative is going to be seized by the States. You have a lot of testimony before you; these 7,000 pages of testimony should be reflected in 50 State legislatures. Some of them have already gone ahead, and they would have to be reversed if those terms are legitimate, so South Dakota is only the tip of the iceberg.

Senator PROXMIRE. Now some securities firms argue that if they're to be kept out of the banking business by shutting down the nonbank bank loophole the banks should similarly be kept out of the securities business. Specifically, they cite the decision by the Fed to allow bank holding companies to acquire discount brokerage firms and contend that bank holding companies should be required to divest themselves of these operations.

LOGIC OF SECURITIES INDUSTRY POSITION

Why did the Fed permit bank holding companies to get into the discount brokerage business and isn't there some logic of the position taken by the securities industry?

Mr. VOLCKER. There's a logic, I think, that the thing ought to run in both directions when you set the boundaries. The question is where the boundaries should lie. We permitted discount brokerage because, in the first instance, we felt it was permitted by the language of the Glass-Steagall Act and, second, that it was reasonable public policy, that it did not pose financial risks or the kinds of conflicts of interest to bank holding companies that the policy of the Bank Holding Company Act was directed against. It was, in that sense, a straightforward decision.

That very decision is before the Supreme Court now. It has been challenged and we will see how the Supreme Court judges the language in the Glass-Steagall Act. But in that area, I would say, again, Congress has an opportunity to pronounce its judgment, and we and the courts are simply applying the language that exists; you can change the language.

Senator PROXMIRE. Now insurance agents who have testified before us recently contend that title VI of Garn-St Germain prohibits a bank holding company from engaging in insurance activities even if those activities are carried out through a State-chartered bank.

Do you agree with that interpretation of title VI?

Mr. VOLCKER. That is a question we would have to face directly with a case before us, and I hesitate to pronounce a final judgment on it. It sounds to me as though that's the logic of the situation, but what the lawyers say in the end we'll have to see.

It does seem to me that that was probably the intent, as I would judge it at this point, but whether it meets all the legal tests, I can make no pronouncement on at the moment.

Senator PROXMIRE. Well, would more emphatic clear language in the bill that we hope to enact this year be helpful?

Mr. VOLCKER. Yes; I think this is essentially what we're suggesting. You ought to tell us what areas of business as a matter of national policy you want to prohibit to bank holding companies, whatever the States do. I would greatly urge you to give us that guidance.

Senator PROXMIRE. Now, there's been some criticism of the closing of neighborhood banks and the fact that moderate- and low-income people have difficulty getting access to human being tellers and they have to use automatic machines which are complex and forbidding to many people.

What's your reaction to these assertions and suggestions that maybe banks should provide more of a public utility service to people of modest income?

Mr. VOLCKER. I think there's always been a correlation, in a sense, growing out of the special role of the banks, the special protections of banks, that they have a responsibility to provide service to the community, and that is reflected directly in the Community Reinvestment Act and other pieces of legislation.

I think what we are dealing with here is a precise application of that policy, and I hesitate to try to draw up general rules applicable around the country as to when a bank needs a physical presence of a branch as opposed to an automatic teller machine. I think my inclination would be to say those kinds of problems, which are extremely difficult at the margin to deal with in particular instances, can continue to be dealt with through the existing legislative apparatus that we have, particularly the Community Reinvestment Act.

Senator PROXMIRE. In the so-called *Beehive* case, the Federal judge found that a bank that only offers NOW accounts is not a bank for purposes of the Bank Holding Company Act. Supposing this decision is affirmed by the higher courts and Congress does not clarify the law, what would be the long-term implications for the strength and structure of the banking industry?

Mr. VOLCKER. The implications wouldn't be very long term. I think they would be rather short term. I think it would greatly expand the loopholes. There's nothing to prevent banks or nonbanks from setting up institutions that take NOW accounts, that do a full range of banking business any place in the country they want to do it. It's a cumbersome—slightly cumbersome—but very effective way to do interstate banking.

Senator PROXMIRE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Mattingly.

PARTICIPATION OF BANKS IN MUNICIPAL REVENUE BONDS ACTIVITIES

Senator MATTINGLY. Thank you, Mr. Chairman.

I'd like to ask a few questions regarding allowing banks to underwrite municipal revenue bonds. Would allowing banks to participate in these activities lower the cost to the user or lower the cost to the issuer? In other words, would there be a benefit to State and local governments?

Mr. VOLCKER. You would think there would be a presumption in that direction; if you allow more producers in the process, they bid against each other. The municipalities can certainly insist they bid against each other, and you would presume that would put pressure to lower underwriting costs. The studies I have seen in the past point in that direction.

Senator MATTINGLY. Is allowing the banks to underwrite municipal revenue bonds, in your opinion, too risky for the banking business?

Mr. VOLCKER. No. We have long supported the idea of banks participating in the underwriting of municipal revenue bonds.

Senator MATTINGLY. You regard that as a proper activity for banks?

Mr. VOLCKER. Yes.

Senator MATTINGLY. In support of allowing banks to offer and sponsor mutual funds, the argument is often proposed that the banks are already in the funds management business, therefore, certainly in a good position to offer mutual funds.

Do you agree with that assessment?

Mr. VOLCKER. They're already in the investment banking business. I think the one question that really comes to my attention is the possibility that with an overly traded and quoted mutual fund the bank exposes its hopefully good name to the vicissitudes of the market a little more than with its current investment activity. The suggestion has been made that these funds operate under a different name than the bank itself. I think that's something that the committee should consider.

There are other conflict of interest problems that can arise, including the possibility that a stock fund could hold large amounts of stock in a company in which the bank itself has a substantial exposure.

I think these questions can be taken care of by appropriate provisions to protect against conflicts of interest.

Senator MATTINGLY. Could the same thing happen to trust department activities?

Mr. VOLCKER. Yes. These problems already exist, and I think that potential problems exist. I do think there has to be strong insulation built up between those running the investment company or the trust side of a bank and those running the lending side of the bank, and I would think that kind of thing ought to be incorporated in the legislation.

Senator MATTINGLY. Couldn't that be done through a separate subsidiary?

Mr. VOLCKER. They would have to be done through a separate subsidiary in the first instance under any of these versions of the bill. I think you start from the fact that they would be done under a separate subsidiary. Then you might have a different name, have different officers and employees and the like; we've raised some questions along those lines in the testimony.

Senator MATTINGLY. Your position regarding the closing of the South Dakota loophole borders on abolishing the dual banking system, while I have always been a strong supporter of States rights, doesn't your recommendation go a little too far in that area and leave little discretion to the States in regulating State-chartered institutions?

Mr. VOLCKER. I don't think it abolishes the dual banking system. I think it would allow the dual banking system a range of initiative and independence within the general structure set by the Congress for holding companies, and that seems to me appropriate. I don't see how you can do it any other way. If you do have a national policy interest, and you're limiting the boundaries of the powers of a bank and a bank holding company, and those essential purposes could or would be undercut by State action, then you have to deal with it. But I don't think that's true in every area and with every type of activity. You can leave some flexibility.

The dual banking system has existed for many, many years and it's had some advantages, along with some problems, but it's been based upon a kind of comity of interest where the States did not enact and administer widely different rules for banking that differ from what is imposed by Federal law. That is the risk we have now, and I think that has to be dealt with.

EFFECT OF $100 BILLION DOWNPAYMENT ON INTEREST RATES

Senator MATTINGLY. A little off the subject of bank deregulations, but you stated in your previous testimony that if the Congress passed a downpayment of $100 billion that interest rates would come down. Congress is about to try and pass a package and last week the prime rate was raised. It's rumored that the Fed is about to raise the discount rate.

Assuming Congress passes a downpayment, will the interest rates go down or are they going to rise?

Mr. VOLCKER. This is quite a different subject, Senator. I'm reluctant to add any more confusion to the record. What I said in the past, for purposes of example, is that if the budgetary deficit were reduced by $50 billion now, you might expect interest rates to be something on the order of 1 percent lower than they would otherwise be.

Senator MATTINGLY. The Washington Post this morning reported Argentina is not going to make their interest payments when they come due. Is that going to affect interest rates?

Mr. VOLCKER. I think that reflects a continuing problem, not just with Argentina but with the sensitivity of these issues more generally. There is a kind of calendar event threatening in this case, because there's a lapse on their payments if they don't pay soon; that involves, under the ordinary accounting and regulatory rules, that those loans would move to a nonaccrual status—at least temporarily.

Senator MATTINGLY. I didn't mean to get you off course asking you about that downpayment and their effect on interest rates, but there's a lot of interest in America about the subject.

In conclusion, I believe that the action by the States to form regional banking groups should be allowed and, of course, I've introduced legislation to permit that arrangement. I applaud your action to permit the Bank of New England to acquire the Connecticut Bank & Trust Co., and I agree with your that any congressional blessing of the regional arrangements should be on a temporary basis.

Mr. VOLCKER. I would frankly expect that one of these days that's going to be challenged. It is a very murky constitutional area as things now stand. It all turns upon, as I understand it, whether the Congress, in passing the Douglas amendment in the first place intended to authorize the discriminatory arrangements that are inherent in regional interstate arrangements. But with regard to these regional compacts, there is to this nonlegal mind, a strong argument that they are not constitutional. This judgment turns upon, as I have stressed, an interpretation of what Congress had in mind in passing the precise language of the Douglas amendment and there isn't a lot of legislative history on that matter. We approached the interpretive issue from a narrow point of view: Is there clear and unequivocal evidence—I think those were the words that we used—that it's unconstitutional? We only said it's not clear and unequivocal.

Senator MATTINGLY. OK. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, returning to page 7 of your statement, you recommend that current orders of nonbank banks be required to divest themselves of these institutions over some reasonable transition period once Congress has agreed on the new definition of a bank, and then in your testimony you list 53 holders of nonbank banks and five general categories.

QUESTIONS ON DIVESTITURE

I'd like to ask you three questions. First, can you provide the committee with some additional detail on how you expect divestiture to work?

Mr. VOLCKER. Yes, I'm sure we could, but the amount of divestiture that would be necessary would depend in the first instance on what kind of a bill you passed. If you pass a bill that followed the lines, let's say, of Senator Garn's bill, there wouldn't need to be much divestiture because many of these combinations would be permitted by the new bill. His bill has an effective date—I don't recall exactly the date—of approximately a year ago or a little less than a year ago, and that might be adequate under those circumstances with a broad bill; there would be, then, relatively little need for divestiture, only for those that were duly warned that they were outside the scope of the chairman's bill.

The CHAIRMAN. That was July 1.

Mr. VOLCKER. July 1. Now if you had a quite different kind of bill, a very narrow bill that defined a bank and said, "This is it, this is public policy, they can't do anything: they don't have insurance powers and they don't have underwriting powers or brokerage powers, revenue bonds, investment companies, real estate development powers," then I would say, in accordance with that policy decision, yes, you indeed ought to go back and say we're starting over again. Let's start in the same playing field and have everybody stay in their own compartments.

Senator DIXON. You've answered my second question. Now as to the third. What will happen to the nonbank banks that are divested under this legislation? What occurs with respect to them?

Mr. VOLCKER. Again, in what I may call Chairman Garn's version of the bill, there aren't going to be all that many of them, and they are going to be relatively small, I think. I don't know of any major problems that would arise, and I think they could be easily sold to a bank, or the method of operation could change, or they could be liquidated. I don't think that's a problem.

You have a bigger problem if you have a very narrow bill and then much more divestiture would be necessary. But again, you would have to go through those several alternatives.

Senator DIXON. Pursuing the question that was previously asked by Senator Mattingly with regard to the South Dakota matter, as I understand your testimony, what you're suggesting is that when safety and soundness is at issue that the Federal Government preempts the whole question with respect to what South Dakota would do.

Mr. VOLCKER. Yes.

Senator DIXON. On ethical considerations, if I understand you, you leave it to the respective States what they may do.

Mr. VOLCKER. Right.

Senator DIXON. So in effect you do protect the dual banking system by virtue of the fact that you say acting within their own borders they do whatever they care to do regarding questions like this.

Mr. VOLCKER. Yes; that's essentially the approach I propose.

Senator DIXON. But you do prevent what happens in the South Dakota case in connection with going outside the borders of the State to other States?

Mr. VOLCKER. Yes, I would prevent that in any case.

Senator DIXON. I think that would be very important for a State like mine which have what could be characterized as less progressive banking laws than some other States in respect to what might occur if the South Dakota question is continued to be permitted by the Congress. Would that not be your interpretation?

Mr. VOLCKER. There's no question about it. If individual States go ahead and do this, other States are forced to do it or feel forced to do it simply out of self protection. They may think it's lousy public policy, but if they're faced with a lousy public policy that's being imposed upon them by another State and they're going to lose competitive position in the banking world, they are going to go ahead and do it anyway, against their instincts as to what the appropriate banking policy should be.

Senator DIXON. I would certainly share your concern and the concern of the chairman that in that area particularly we ought to act this year because I see that as a matter that will obviously proliferate very quickly if nothing is done here in the Congress.

Mr. VOLCKER. I certainly agree with that, but I would simply say that I think all these questions become easier when they're not dealt with in isolation but balanced one against the other. I think that is an essential part of the legislation, but only part of the package.

RECIPROCITY IN STATE/FOREIGN NATION BANKS

Senator DIXON. The chairman has introduced a separate bill—as I understand it, Mr. Chairman, it is a separate bill, S. 2193 on the question of reciprocity in connection with situations such as existed recently in my State where foreign banks have come into Illinois under circumstances where our banks are not permitted to come into that foreign jurisdiction which is a matter of substantial concern in the banking community in my State.

I would ask you, although I have not raised the question with the chairman on a prior occasion, whether you think that might be appropriate legislation to consider as part of whatever legislation we might mark up in this committee.

The Chairman. If I could just respond, it was introduced originally as a separate bill but it is title X of S. 2181.

Senator DIXON. I did not know it was a part of this bill as a separate title.

Mr. VOLCKER. You either have a letter or a letter is on its way commenting on that proposal in general terms. I might prefer to let that delicate language rest in its written form. But, in general, it says that there is an issue here but let's not try to make reciprocity a dominating, precise consideration, because it's very difficult to apply in particular instances. If legislation approached it from the standpoint of factors to be taken into account in particular circumstances, it might be useful, but we want to go on the basic principle that a foreign bank in the United States is entitled to do what a U.S. bank in the United States can do, and that our entry into that market, whether it's by a domestic company or a foreign company, ought to be assessed on similar criteria.

Senator DIXON. Have you directed that letter to all members of the committee?

Mr. VOLCKER. No, I have not. In fact, it was to the House. I can send it up to you. It's a letter that went to a Member of the House of Representatives.

Senator DIXON. I'd appreciate it very much if you would send that letter since it's an important question in my State.

[The following letter was subsequently submitted for the record:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

March 27, 1984

The Honorable Alan J. Dixon
United States Senate
Washington, D.C. 20515

Dear Senator Dixon:

During the hearing on banking legislation this morning, you mentioned the proposal by Senator Garn to introduce an element of reciprocity into the admission of foreign banks into the United States. Enclosed is a copy of my letter to Jim Leach that I mentioned at that time. If you have any further questions on this subject, please feel free to get in touch with me.

Sincerely,

Paul

Attachment

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

March 27, 1984

The Honorable Jim Leach
U. S. House of Representatives
Washington, D. C. 20515

Dear Jim:

In your letter of January 3, 1984, you asked for the Federal Reserve's views on a bill introduced by Senator Garn (S. 2193). The proposed legislation would require the Comptroller of the Currency, in licensing federal branches and agencies of foreign banks, to "take into account . . . whether or not United States banks are permitted to conduct business in the home country of the applicant."

In considering legislation of this kind, it is important to bear in mind that U. S. banks are able to have some form of banking presence in most banking markets abroad. The exceptions, where entry is not permitted at all, are mainly in developing nations. In some other markets, restrictions on entry and operations have been lessened. In Japan, for example, previous governmental restraints on foreign banks establishing branches have largely been eliminated, and foreign banks essentially are accorded national treatment with respect to branching. In addition, there are no longer restrictions on foreign banks competing for local deposits. Access to other markets also has improved, as in the cases of Canada and Spain. There are currently signs of movement in the direction of allowing the entry of foreign banks in Sweden and Australia, where access as banks has been barred for many years.

While important progress has been made to date in obtaining access to foreign markets for U. S. banks, I have some sympathy for authorizing Federal banking agencies to consider a wider range of criteria in acting on requests by a foreign bank to establish or expand its U. S. banking presence. Senator Garn's bill avoids some of the serious drawbacks of reciprocity legislation by considering foreign treatment of U. S. banks as only one factor to be taken into account in authorizing a foreign bank's presence in the United

States. Similarly, the bill does not require that the foreign country concerned afford the same manner and degree of market access to U. S. banks as we afford foreign banks in order for a bank from that country to have a U. S. presence. In practice, such a reciprocity standard would raise significant problems of measuring equivalency of treatment and of achieving comparability among countries.

However, Senator Garn's bill raises a number of questions, including whether its approach could, in fact, result in equalizing competitive opportunities. As a practical matter, a significant number of major banks from the more restrictive countries are already established in the United States. In addition, foreign banks can enter U. S. markets not only by federal licensing of branches and agencies, but also through establishment or acquisition of subsidiary banks and by State-chartered branches or agencies.

I would be concerned if such legislation could be interpreted as "anti-foreign bank" and protectionist in intent or substance. Apart from the competitive benefits of foreign banks, such legislation could undermine efforts now under way -- as called for in the International Lending Supervision Act -- to work closely with and encourage foreign supervisory authorities to achieve coordinated supervisory policies on international lending and acceptable capital standards for multinational banks.

You have also asked whether there are additional legislative issues that Congress should address, in order to improve or strengthen the International Banking Act of 1978 ("IBA"). A number of policy issues have arisen which are mainly of a prudential and supervisory concern for which adequate legislative authority is available under the IBA. The Board has some legislative recommendations, mainly technical, for revisions in the Edge Act and other laws. These proposed statutory changes are described in the enclosed memorandum.

If you should have further questions on these or other matters pertaining to foreign banking operations in the United States, I would be pleased to discuss them with you.

Sincerely,

Paul

Enclosure

PROPOSED LEGISLATIVE CHANGES AFFECTING EDGE CORPORATIONS AND FOREIGN BANK OPERATIONS IN THE UNITED STATES

On September 17, 1980, the Board of Governors of the Federal Reserve System submitted a report to Congress on the implementation of the International Banking Act of 1978 ("IBA") containing several recommendations for statutory changes based on the Board's experience in implementing the Act. These changes were largely technical amendments to the Edge Act and other laws.

Many of these proposals would still appear to warrant legislative action and, in light of further experience, several additional modifi~~cations in~~ present law would be appropriate. Each proposal, with a brief explanation, follows:

A. RECOMMENDATIONS AFFECTING EDGE CORPORATIONS

Statutory and regulatory changes made in 1978 and 1979 have had important effects on Edge Corporations. More banking offices of Edge Corporations have been opened during the past four years than were opened in the preceding 60 years. Assets have continued to grow at a rapid rate. More banks have established Edge Corporations for the first time than during any comparable short-term period. At the same time, Edge Corporations have generally remained strong and have increased their reported profitability.

Several additional statutory changes are recommended, however, largely with the objectives of making the legislative framework applicable to Edge Corporations: (a) more closely comparable to that applicable to U. S. branches or agencies of foreign banks with which Edge Corporations compete, or (b) more comparable to that of U. S. banking institutions where differences no longer appear warranted.

1. Edge Corporation Access to the Discount Window

With the exception of Edge Corporations, all U. S. depository institutions, including U. S. branches and agencies of foreign banks, have comparable authority to borrow from the Federal Reserve discount window. Edge Corporations are required to maintain reserves against deposits and there appears to be no policy reason to continue to deny Edge Corporations the same rights of access to the discount window as are available to other depository institutions.

2. Ownership of Edge Corporations

The IBA amended the Edge Act to permit foreign banks, or U. S. banks that are majority-owned by foreign banks, to have a majority ownership interest in Edge Corporations. This privilege was not extended to foreign individuals or to U. S. banks that are majority-owned by foreign individuals. Approximately 70 U. S. banks are now owned by foreign individuals, and there does not appear to be any persuasive policy reason for discriminating against such foreign-owned U. S. banks in their ability to acquire Edge Corporations.

The Edge Act by its terms does not prohibit U. S. nonbank ownership of an Edge Corporation, yet an Edge Corporation can, like a bank, both make commercial loans and offer transaction accounts -- so long as its business is international or foreign in character. Thus, the Edge Act should be revised in order for the rules applicable to ownership of an Edge Corporation to be made expressly comparable to those applicable to other U. S. banking institutions. It would be particularly important for this issue to be addressed if Edge Corporations are provided access to the discount window comparable to access authorized to commercial banks.

While prior approval of the Board is explicitly required before a foreign bank acquires the majority of shares of an Edge Corporation, no similar explicit statutory provision requires prior Board approval of an acquisition of control of an Edge Corporation by a U. S. person. While such authority can be implied from various provisions of the Federal Reserve Act, amendment of the Edge Act for a change in control procedure similar to that applicable to member banks, whomever the acquirer, appears desirable.

3. Limitations on investments in Edge Corporations

The Edge Act currently restricts the investment by a bank in an Edge Corporation to 10 percent of the bank's capital and surplus. Given the satisfactory experience in the operation of Edge Corporations, this restriction no longer appears necessary as a prudential matter, and in some cases may have inappropriately hampered growth of Edge Corporations.

4. Examination Frequency

The Edge Act currently requires Edge Corporations to be examined once a year. Edge Corporations are generally better-capitalized than banking institutions and by-and-large have been found to be in very sound financial condition. In light of this experience, amendment of the Edge Act to allow for examinations to be conducted with such frequency as the Board considers appropriate -- as is the case for member banks -- appears reasonable.

5. Technical amendment

As a matter of business convenience, the Edge Act should be amended to permit an Edge Corporation to hold its annual shareholders' meeting not only at its home office in the United States, but also at any other location in the United States as fixed in its by-laws.

B. FOREIGN BANKING OPERATIONS IN THE UNITED STATES

The IBA can generally be viewed as placing U. S. and foreign banks on a more equal footing with respect to their U. S. operations. Some revisions of statutes to further that objective would be desirable. In addition, statutory modifications may be useful to enhance the ability of the banking agencies to obtain information from foreign banks and foreign supervisors useful in the examination and supervision of foreign banking operations in the United States.

1. Reserve requirements

U. S. agencies of foreign banks with total worldwide assets of less than $1 billion and commercial lending company subsidiaries (New York state Article XII Investment Companies) of foreign banks are the only two banking vehicles for a foreign bank presence in the United States which are not subject to reserve requirements. Because all U. S. depository institutions, regardless of size, are subject to reserve requirements, such exemptions for foreign bank offices do not appear warranted.

2. Interstate restrictions

Under the IBA, every foreign bank with a subsidiary bank or full service branch in the United States has had to select a "home state," which is the only state in which the foreign bank is authorized to expand its domestic deposit-taking activities. A foreign bank may exercise a one-time change in home state, but only if it restricts its domestic deposit-taking activities in its original home state to those that were grandfathered.

Section 3(a)(4) of the Bank Holding Company Act permits a multi-state bank holding company or a foreign bank with bank subsidiaries outside its home state to acquire additional banks by asset acquisition outside its principal state of operations and home state, respectively. The appropriateness of this provision should be considered by the Congress.

3. Supervision and reporting

In order to enhance the degree to which information about the condition of banks can be exchanged with bank supervisory authorities in other countries, amendments would be desirable to those U. S. laws that impose criminal penalties for releasing to outside parties information obtained through the bank examination process. In recent years, legislation abroad has authorized foreign banking authorities to enter into arrangements for suitable exchanges of information. It would be desirable for U. S. authorities to be able, in appropriate circumstances, to exchange information with foreign supervisors on foreign bank operations in the United States as well as U. S. bank offices abroad. There might be times as well when U. S. and foreign supervisory authorities engage in examination activity on one another's behalf. Accordingly, U. S. legislation should provide flexibility for the foregoing arrangements to be entered into. It may also be useful, as a supervisory matter, to mitigate concerns of foreign banks regarding the possible disclosure of confidential information required to be provided to U. S. bank supervisors, by specifying by statute, that the confidentality of such supervisory information can be maintained.

The CHAIRMAN. Would the Senator yield for a correction?

I jumped when he said reciprocity and we are dealing with two different reciprocity bills. Title X in S. 2181 is domestic reciprocity. The international reciprocity bill which I introduced is still a separate bill and not part of S. 2181.

Senator DIXON. I would like to suggest that we might want to consider that as part of this bill and I'd appreciate the letter from the chairman concerning the view of the Fed about that question.

The CHAIRMAN. I feel very strongly about the issue and, as the Senator from Illinois knows, in December that was the major purpose of going to Australia, to let the new Government know how strongly we felt. Australia is not the only country that has some privileges superior to some of our domestic banks. Australia has one bank that operates in five different States in the United States and, unfortunately, their committee report is not very satisfactory that allows a very limited amount of U.S. banks or foreign banks into Australia. So I want to make sure I clarify that we're talking about two different types of reciprocity and the international reciprocity is not in the bill.

Senator DIXON. Well, I thank the Chair and I'd appreciate the letter from Chairman Volcker and the consideration of the chairman about the possibility of an additional title in this bill on foreign reciprocity questions.

May I finally ask this in conclusion, Mr. Chairman. Senator Mattingly asked you about increasing interest rates and I don't want to get into that in great detail, but would you attribute the fact that interest rates are rising slightly to either (1) the budgetary deficit;

(2) the perception in the banking community that you're going to tighten the monetary supply?

Mr. VOLCKER. I think that you don't have to look very far for a very straightforward explanation. We have a continuing high budget deficit. That situation has not changed, but we have very rapid growth in some measures of credit currently—or rather rapid growth; if I put very in people will jump up. The economy has been rising strongly. Under those conditions we now have the addition of considerable private credit demands and continuing governmental credit demands during a period where—I'm not projecting into the future—looking back over the past 2 or 3 months, you have had a high rate of economic growth. That's a set of circumstances that is sometimes accompanied by upward pressures on interest rates.

Senator DIXON. Are you planning to restrict the monetary supply in the short-term future?

Mr. VOLCKER. We are meeting on that subject. We will appropriately restrict, as always. We will try to reach a judgment about precisely what to do about that shortly.

Senator DIXON. I have no further questions.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you.

Mr. Chairman, just a followup on Senator Mattingly's question about this morning's Washington Post story about Argentina, if they do default, what effect will this have on the prime rate.

Mr. VOLCKER. I don't think that has any direct effect on the prime rate, but you're dealing with a problem, looked at in the larger perspective, of a large number of credits abroad that if not carefully managed could have effects on the domestic credit markets. That's the point I've made over and over again. I would not look at it just in the context of Argentina alone. Argentina is only one country. Nor would I want to exaggerate the effect of this particular date. It's not a default because they miss a particular date in the sense that you may mean the term. Negotiations are underway with the IMF and, indeed, I am somewhat encouraged by the attitudes that I have seen recently. I think there is some real progress as this date has approached and I think that progress is encouraging. This story is not over yet and that date is not as magic as the question may imply.

Senator HECHT. Well, last year I asked you about your reservation regarding combining banking and insurance and banking and property development. You stated that you would not be recommending that course right now. Have you changed your mind?

FED CONCERNED ABOUT BANKS GETTING INTO REAL ESTATE DEVELOPMENT

Mr. VOLCKER. We have always expressed concerns about the real estate development section of the bill. There are limitations; the basic limitation is investment in the real estate development subsidiary of 5 percent of capital. I have also at least tried to define what is meant by real estate development in a way that we would find satisfactory.

Senator HECHT. Well, real estate development is basically real estate development.

Mr. VOLCKER. I wish I knew exactly what people had in mind when they say real estate development. I ask banks what they have in mind and they say what they have in mind is something along the lines of what we put in the testimony, but I am well aware that real estate development can be interpreted as meaning practically anything, and that's my concern.

Senator HECHT. So rather than 5 percent, it could grow larger at any time after it once was implemented?

Mr. VOLCKER. The capital would be related to the size of the organization's capital. That limit would remain. That is just the amount of capital that the holding company could put into the real estate development subsidiary. That capital, in turn, could be leveraged and there's that further regulatory question of how much leverage would be permitted.

Senator HECHT. Which in essence would give greater advantage to the larger institutions than the smaller institutions?

Mr. VOLCKER. In terms of sheer size, yes.

Senator HECHT. Is this healthy?

Mr. VOLCKER. I think it's true that a large institution can make larger loans than a small institution. It's inherent in the size of the organization.

Senator HECHT. Well, I stated before that there are 14,500 commercial banks in America today but if a lot of these provisions would come forward it could drop drastically, which would mean that we would be on the course of Europe perhaps and Canada with just a few major banks. Do you see this possibility?

Mr. VOLCKER. I do not see the day when the U.S. banking system would look like that in Canada or other countries that have a highly concentrated banking system. I certainly can see the number of banks being reduced over the years. You have 14,000 banks, as you say, but I don't think some reduction in 14,000 banks implies anything like the situation you have in Canada where there are 4 or 5 very large banks and relatively few secondary institutions. I don't see that situation at all.

I would look at the situation, for instance, in California which seems to me an extreme example; we've had statewide branch banking and very large family banks for years and years, and yet there is still a rather healthy climate for smaller banks and for the creation of new banks.

Senator HECHT. You have stated often that banking institutions can never be truly separated from the portions of their affiliates. Would you rather have these additional powers conducted within the bank?

Mr. VOLCKER. No. I'd rather have them conducted for the most part in a separate affiliate. The point that I made then and would make again, is that simply conducting them in a separate affiliate does not provide full assurance that the fortunes of the bank and the holding company as a whole are not going to be affected by the fortunes of their particular nonbanking affiliates. I think experience shows quite the opposite. It gives you an element of protection but not complete protection.

Senator HECHT. So how would you go about examining banks then as far as the liquidity and capital structure if they're part of the affiliate?

Mr. **Volcker**. Banks would be examined in the same way. In addition, in these bills, we would have the responsibility for supervising and regulating the holding company and the other affiliates of the holding company, with as strong an injunction as possible to rely upon other supervisory authorities. For instance, in the insurance area, the insurance affiliates would presumably all be regulated by State insurance authorities and in the securities area the affiliates would come under certain SEC or stock exchange or other regulations.

Particularly in the areas where major risk taking would be undertaken, there is likely to be some other parallel regulatory apparatus more deeply involved in the operations of that affiliate, but we would have an oversight responsibility.

Senator **Hecht**. Do you feel you could do that adequately?

Mr. **Volcker**. Yes, given that the others would have a degree of regulation if it was deemed appropriate in any event. I think, within the limitations of the kinds of powers in Senator Garn's bill, we could do it. If you opened it up completely, so that there could be any combination of banks with any other kind of business, I think the answer would have to be no, we haven't that kind of capacity, that kind of experience. But that's not what is being proposed, and one of the basic reasons it's not being proposed is because it would, I think, conflict with the safety and soundness and impartiality of the bank itself. There are limits to my statement, but taking the framework of the proposals before you I think we could do it.

STRICTER REGULATIONS NEEDED ON BROKERED DEPOSITS

Senator **Hecht**. These regulatory powers sometimes scare me looking down the future. The head of the FDIC said that it was impossible for them to regulate some of these banks because of the brokered deposits and they stated several banks had over 50 percent of their assets and footings in brokered deposits. They said they were unable to regulate this and it came on them—and I questioned whether it should have—this is under the existing laws—and so it worries me out into the future about these types of regulatory powers.

Do you have any concern about right now, that the FDIC and brokered deposits and, they say they cannot regulate them?

Mr. **Volcker**. I have the concern that I expressed earlier to Senator Garn who asked the question; there are other ways of dealing with the brokered deposits problem, but that would take legislation. I would invite you and encourage you to add a provision to the legislation before you to permit what I think would be a preferable way of dealing with this problem.

Within the context of the present law, the approach adopted by the insuring authorities seems to me necessary, given the present limitations.

Senator **Hecht**. Then you absolutely advocate some action on these brokered deposits?

Mr. **Volcker**. Yes, I do.

Senator **Hecht**. Many banks are setting up arrangements with various services like insurance and real estate brokerages. Do you see any problems here?

Mr. **Volcker**. I think there could be problems, depending upon congressional policy. If you don't provide for bank holding companies doing this directly, then there will be pressures to do it indirectly; then the questions will arise as to how you define a "legitimate degree of cooperation," if that's the right term, with an insurance broker or a real estate broker by a bank, and at what point is congressional policy really being evaded to separate these two activities. I think you would have to give them some guidance on this score.

For instance, you might have an office or an availability within a bank under an ordinary fixed rental arrangement and that may be perfectly acceptable, but if you made an arrangement with the broker or the insurance agent that was essentially a profit-sharing kind of arrangement it might raise questions if you concluded, as a matter of congressional policy, that the two should be separated. We would need some guidance on such points.

Senator **Hecht**. My time is up. Thank you, Mr. Chairman.

The **Chairman**. Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

We had a markup this morning in the Commerce Committee which is still going on and I apologize that it prevented my being here when you started.

Would you be kind enough to send us any suggested language you might have on the brokered deposit issue which you were discussing with Senator Hecht, since you said that we might want to treat this legislatively? I would be interested in any specific language that you might offer to the committee.

[The following information was subsequently submitted for the record:

SUGGESTED LANGUAGE ON THE BROKER DEPOSIT ISSUE
FROM
THE FEDERAL RESERVE SYSTEM

SHORT TITLE

SEC. 1. This Act shall be referred to as the "Financial Institutions Supervisory Improvements Act of 1984".

LIMIT ON INSURED BROKERED DEPOSITS

SEC. 2. No insured depository institution shall accept an insured deposit placed by or through a deposit broker if accepting such a deposit would cause the outstanding amount of the institution's insured deposits placed by or through deposit brokers to be in excess of five per centum of its daily average total deposits for the three month period ending on the day before the deposit is placed.

TRANSITIONAL ADJUSTMENT PERIOD

SEC. 3. (a) An insured depository institution with outstanding insured deposits placed by or through deposit brokers in excess of five percent of total deposits on the date of enactment of the Financial Institutions Supervisory Improvements Act of 1984 shall have a transitional period of six months from the effective date of this Act to first comply with the limit established by section 2.

(b) During the transitional period, the limitation applicable to such an insured depository institution shall not exceed the amount of its insured deposits outstanding placed by or through deposit brokers on [date bill is introduced]. The appropriate Federal supervisory agencies shall, at their discretion, issue joint rules and regulations under Section 5 of this Act establishing such additional limitations during the transitional adjustment period as may be required to assure compliance with section 2 of this Act at the end of the transitional adjustment period.

DEFINITIONS

SEC. 4. As used in this Act--

(a) (1) The term "deposit broker" shall mean--

(A) any person engaged in the business of (i) placing funds, or facilitating the placement of funds, of third parties with insured depository institutions, or (ii) placing funds with insured depository institutions for the purpose of selling interests in those deposits to third parties;

(B) an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan; and

(C) a trustee or plan administrator, including an investment advisor acting in connection therewith, of a Keogh Plan or Individual Retirement Account established pursuant to 26 U.S.C. §§ 401, 408.

(2) Notwithstanding paragraph 1, the term "deposit broker" shall not include such persons or entities as determined by joint rules and regulations issued under Section 5 of this Act.

(b) The term "insured depository institution" shall mean an insured bank, as defined in section 3(i) of the Federal Deposit Insurance Act, an insured Federal savings bank, defined in section 3(t) of the Federal Deposit Insurance Act, or an insured institution, as defined in section 401(a) of the National Housing Act.

(c) The term "deposit" shall have the same meaning as in section 3(l) of the Federal Deposit Insurance Act, and shall include deposits, accounts, or shares authorized for associations under section 5(b)(1) of the Home Owners' Loan Act of 1933.

(d) The term "insured deposit" shall mean (1) an insured deposit as defined in section 3(m) of the Federal Deposit Insurance Act; or (2) an insured account, as defined in section 401(c) of the National Housing Act.

(e) The term "appropriate Federal supervisory agency" shall mean (1) the appropriate Federal banking agency, as defined in section 3(q) of the Federal Deposit Insurance Act, with respect to an insured bank, as defined in section 3(i) of such Act, or a deposit broker that conducts business with an insured bank; and (2) the Federal Home Loan Bank Board with respect to an insured institution, as defined in section 401(a) of the Natonal Housing Act, or a deposit broker that conducts business with an insured institution.

REGULATIONS

SEC. 5. The Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board shall adopt jointly such rules and regulations as necessary to effectuate the purposes of this Act and to prevent evasions thereof.

PENALTIES

SEC. 6. (a) Any insured depository institution, any officer, director, employee, agent, or other person participating in the conduct of the affairs of such an insured depository institution violating any provision of this Act, or any regulation or order issued under the authority of this Act, shall forfeit and pay a civil money penalty of not more than $10,000 per day for each day during which such violation continues: Provided, That the appropriate Federal supervisory agency may, in its discretion, compromise, modify, or remit any civil money penalty which is subject to imposition or has been imposed under authority of this section. The penalty may be assessed and collected by the appropriate Federal supervisory agency by written notice. As used in this section, the term "violates" includes without any limitation any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation.

(b) Any action to impose a civil money penalty shall otherwise follow the procedures set forth in section 8(i)(2)(ii) through (vii) of the Federal Deposit Insurance Act for the appropriate Federal banking agency, as defined in section 3(g) of the Federal Deposit Insurance Act, or section 407(k)(3)(B) through (G) of the National Housing Act for the Federal Home Loan Bank Board.

EFFECTIVE DATE

SEC. 7. This Act shall become effective ninety days after enactment.

SECTION BY SECTION ANALYSIS

SEC. 1. This Act may be cited as the Financial Institutions Supervisory Improvements Act of 1984.

SEC. 2. This section prohibits an insured depository institution from accepting an insured brokered deposit if such a deposit would cause the insured depository institution to have outstanding insured brokered deposits on the day the deposit is accepted of more than five percent of its daily average total deposits over the previous three months. A violation would not occur if an insured depository institution held insured brokered deposits in excess of the five percent limit by virtue of a runoff of other deposits. However, no additional insured brokered deposits could be accepted until such time that accepting an insured deposit placed by or through a broker would not result in the institution exceeding the limitation on insured brokered deposits.

SEC. 3. A transitional period of six months from the effective date of the Act is provided for insured depository institutions to meet the limit established by the Act. During this period, an institution would have a dollar "cap" on insured brokered deposits equal to the amount of insured brokered deposits outstanding on the date that the legislation is introduced. The supervisory agencies are given the discretion to issue joint regulations requiring a phase-down of or other limitation on insured brokered deposits during the transition period to assure compliance with the 5 percent "cap" at the end of the transition period.

SEC. 4. This section defines key terms, including "deposit broker." A "deposit broker" means any person engaged in the business of placing funds, or facilitating the placement of funds, of third parties with insured depository institutions, or for the purpose of selling participations in shares of deposits to third parties, or one who establishes a deposit account under an arrangement such that the funds would be used to make a prearranged loan. It also includes a trustee or plan administrator, including an investment adviser acting in connection therewith, of a Keogh Plan or Individual Retirement Account. Other terms are defined by reference to existing provisions in the Federal Deposit Insurance Act, the Home Owners' Loan Act, and the National Housing Act.

SEC. 5. The three banking agencies and the Federal Home Loan Bank Board are given joint rulemaking powers to carry out the purposes of this Act.

SEC. 6. Civil money penalties may be imposed by the appropriate federal supervisory agency for violations of this Act. Such penalties may be up to $10,000 for each day that a violation continues. Civil money penalties could be imposed for example, if a depository institution exceeds its limit on brokered deposits.

SEC. 7. The effective date of this title is deferred 90 days from date of enactment.

Mr. **Volcker**. We will do that.

Senator **Riegle**. Thank you. Last week, the Comptroller of the Currency said before this committee that his agency, as you know, would not extend its nonbank moratorium beyond March 31 when it expires.

Now before I ask the question let me say that I'm prepared to see this committee wrap up these hearings and move on to a markup and vote on the issues that are before us. I'm not sure how far we are going to get, quite frankly, as I look at the number of legislative days left. I would guess there are probably about 45 legislative days left this year, assuming that there's no lameduck session, and the House is not moving aggressively on these issues, so I'm not sure that we're going to see a legislative package ultimately produced and sent to the President for signature.

In the absence of legislation being passed, I'm interested in what your reaction is to the moratorium expiring and I'm wondering if just letting it expire in the absence of a change in law is the right policy for us to be following at this point.

Mr. **Volcker**. That's a judgment the Comptroller has to make, and it's at this point only one small piece in the whole picture. As you can see, there are many avenues through which this proliferation of nonbanks, or nonthrifts, or whatever you want to call them, can take place. The States are acting, so I don't think it hinges primarily on that particular moratorium. That is a piece of the whole.

We approved the acquisition of a nonbank bank the other day in Florida by a New York bank because, under existing law, we saw we had no alternative. I think that is the kind of problem you have. This *Beehive* decision that was referred to earlier opens the loophole much wider.

That particular action, while it's not unimportant, I don't think is persuasive in the whole legislative perspective that you have. I think you have to act this year to deal with these problems.

Senator **Riegle**. Well, I agree with you, but if we should not act this year—and I think that there is some considerable doubt that there will be final action taken—would it be your view then that we might have to go back to the moratorium?

Mr. **Volcker**. You mean the Comptroller's moratorium?

Senator **Riegle**. Yes.

Mr. **Volcker**. I think this has gone beyond the point where that kind of moratorium is going to hold anything in place. It makes it easier for this proliferation to take place, but we're going to be approving a lot of nonbank banks simply because we have no alternative under the present law.

Senator **Riegle**. So I gather you're saying then that you feel there's some considerable urgency to our acting this year?

Mr. **Volcker**. I have no doubt about that, Senator.

WHICH OF THE ISSUES ARE MOST URGENT?

Senator **Riegle**. If I may ask along that line, and aside from your personal views about where a corollary of near consensus lies, I'm wondering which of the issues in your opinion are so urgent. I'm asking for the one or two that you think are of the most burning consequence to deal with and that if we don't get everything done it's essential that those things get done—what would be the one or two things at the absolute top of your list that you recommend to us here?

Mr. Volcker. I don't think I can really divide it up that way, Senator. I think there is more of a consensus in the areas of the definition of a bank, definition of a thrift, and the streamlining of the regulatory procedures. The areas where there's more controversy are clearly in the powers area and in the State and Federal relationships area.

The trouble is you don't get the job accomplished without dealing with all these areas. I think they do hang together as a package. I'm not saying every last provision is essential, but I'm saying that there is a package that's essential.

Senator Riegle. Well, I would agree with that, but I'm also concerned that this year is taking on a strange character legislatively and that we have the Senate moving one way and the House moving a different way, the President very substantially disengaged in any personal way from these issues. We have a Presidential campaign intervening. We have a budget crisis on our hands which we're a long way from solving and is going to take up most of our time and the legislative window is closing. We've got 45 legislative days left. So we may not get the package that we agree we need to have.

If it's clear what the one or two absolutely critical urgent items are that we have to address, I think that may help us get something and maybe able to enlarge it into more of a package rather than less of a package. When we passed Garn-St Germain there was a clear feeling that we had a crisis on our hands with the savings and loan industry and that helped propel events to a workable state so we were able to get something done.

I believe there is not today the perception that there is an equivalent kind of crisis. Although I share your concern about where we stand right now and think we ought to be dealing with the issues, it would seem to me if there were one or two issues that literally cannot wait, cannot be pushed off, that we'd better use those as a wedge into this problem to see if we can't get those and as many others as we can handle.

Mr. Volcker. I think you have a crisis today, but a different type of crisis. You don't have a financial crisis in the sense that the health and well-being of particular institutions or groups of institutions hinges in the short run on this legislation. But what you have is a crossroads, if not a crisis. Is Congress going to exert on this whole, emerging, messy situation its conception of where the public interest lies and what direction financial services and banking should take, or is it not? You cannot procrastinate, in my judgment, very long on that decision because if you don't make the decision in a positive way you will have given an answer. All these other pressures and avenues that are opened up will set the direction for you.

Maybe you're at this crossroads rather than at a crisis. You're either going to go through it or you are not, and there's going to be a collision at the crossroads.

What's vital and what isn't? I think what's vital is an integrated package. If you asked me whether every question of powers, for instance, has to be resolved this year, I don't think I can say that; but I think some of them are important areas and have to be solved because that's what the package is all about—what can banks do and what can't they do.

The core of the bill is a definition of a bank, a definition of a thrift. That's the philosophical base of the bill, but I don't think you can really stop there; you have to consider some of these powers one by one and they are a one.

Senator RIEGLE. So just to try it one more time then, you do not see any particular overriding concern or issue that poses special danger or jeopardy that if we were to fail to deal with it this year would carry with it much larger negative consequences?

Mr. VOLCKER. I can say that about any individual power, but I can't say it about them collectively. The consequence is going to be an incoherent structure of banking and the relationship between banking and other institutions—an increasingly incoherent situation if you don't act.

Senator RIEGLE. I'm going to just ask one more question and then I have some for the record.

You've repeatedly stressed before this committee your belief that banks continue to perform a unique and critical role in the financial system of the economy. However, I find it more and more difficult to distinguish the uniqueness of the banks from Merrill Lynch or American Express. I'm wondering if you could maybe again put in your own words what is there that's so unique about a bank and what is so important in your view that we preserve them as much as they are today.

BANKS REMAIN CUSTODIANS OF NATION'S PAYMENT SYSTEM AND MONEY SUPPLY

Mr. VOLCKER. Banks are essentially the custodians of the payment system and the money supply, and that's a pretty important function in any economy and in our economy. They are also the primary—and are going to remain the primary—suppliers of short-term credit for businesses and others throughout the country and I think there is a continuing interest that they exercise that function impartially, which gets into the conflict of interest area. They are the custodians for the savings of this country. They are the dominant financial institutions. Their uniqueness relates to their involvement in money and in the payments system, and I was narrowing the scale a little by speaking of their provision of short-term credit throughout the country.

This has always—or for many, many years anyway—been reflected and recognized in public policy by the protections that we provide uniquely to banks. Why was the Federal Reserve created? Precisely for this reason. Why was the FDIC created? Precisely for this reason. We have an interest in those institutions being sound and stable and providing a continuous, effective service. We've got an interest in other industries, but not with that same degree, not to that same amount of sensitivity. We don't have apparatus for protecting other industries as a matter of course.

It also involves, on the other side, certain responsibilities by those institutions which are reflected in various public policies.

That is, I think, the essential uniqueness of banks. It is a matter of fact. It is a matter of public policy.

Senator RIEGLE. I appreciate that. My time is up.

[Response to written questions of Senator Riegle can be found on p. 1780.]

The CHAIRMAN. Thank you, Senator Riegle.

Let me make this one brief comment about the matter of time. The Senator from Michigan is correct, this is a different and difficult year in a lot of respects, but time on the floor or legislative days is not the key to whether we get a bill or not. This is the kind of legislation I'm sure the Senator well remembers when he was ranking minority member at the tail end of S. 1720 which became Garn-St Germain. It was a matter of working out a balance in the package and then it went through the floor in about 1½ hours and I think we're in the same situation.

We can either work something out this year or we can't, and I just wanted—not for the Senator from Michigan's benefit, but generally for people to understand that the number of legislative days is not the important factor of whether we can put a package together. If we needed 1 week on the floor, then we're not going to get a bill.

Senator RIEGLE. Would the chairman yield on that point? We haven't spoken recently about this, and this is an important point he makes, and I would normally be inclined to agree with that. But let me tell you why I'm not sure that applies this year. That is, first of all, the committee has changed. I mean we have new members on the committee who have not yet been in the markup situation and voted on these issues, so it's not altogether clear today where opinion might lie within the committee, let alone us reaching to a consensus that perhaps you or I, or you and Bill Proxmire, representing the two sides, would agree to, as was the case with Garn-St Germain.

But I'm concerned that depending upon the scope of the package, that the broader the scope and the more it takes in the full range of all the issues, the sense I have from talking to other colleagues is that while we might hammer out something here, I don't know that we can assume necessarily that it would go through the Senate as quickly and as expeditiously as it did the last time, when we had some emergency factors added to the equation. The deeper issues here are fundamental enough that even if we struck a balance in this committee, that once we get to the floor and we have another 80-odd Senators having a chance to take a crack at this——

The CHAIRMAN. There are 80-odd Senators?

Senator RIEGLE. I think there are 100 odd Senators.

In any event, I can foresee that this issue in this timeframe may in fact be more subject to being snarled on the floor than might have been true the last time around, despite the great persuasive powers of the chairman and his allies.

So I would just say that I think we're under some considerable pressure here and one of the things we ought to do is to get ourselves to a markup phase, which I'm sure you have in mind, fairly soon, so we can see where things stand. I appreciate this chance to respond.

The **Chairman**. Senator Heinz.

Senator **Heinz**. Thank you, Mr. Chairman.

Listening to the colloquy between yourself and Senator Riegle caused me to remember the other day when some of our colleagues were debating the virtues of oil company mergers. One of our colleagues got up and said, "Well, you've got to remember, this is all about what made this country great. Greed." [Laughter.]

DIFFERENT LEGISLATIVE CLIMATE IN SECOND SESSION

I think there is a difference between the legislative climate of the last Congress and this Congress. In the last Congress the troubles of the thrifts and 2 years prior, the difficulties the banks were having in competing and the fact that we had not deregulated their liability side, did form cases of national need.

Frankly, at this time we are talking about that which made this country great—greed—and the question is posed to us in effect by the regulators and by the acquisitors: Who are going to be allowed into banking, who are going to be allowed among the banks into nonbanking, how are we going to carve up the pie?

I happen to agree with Chairman Volcker that we need to make some decisions in that area, but I've got to disagree with you, Mr. Chairman, that time is on anybody's side. I think Senator Riegle's characterization of the difference between this year and 2 years ago is the more accurate characterization because it is going to be very difficult to find the engine with which to drive this legislation through the House and the Senate other than greed, which in an election year is not one of the all-time favorite things for Members to vote for.

The **Chairman**. Would the Senator yield just on that point before you go on to the next one? As to the matter of time, I'm not sure I'm being understood by either one of you. I don't disagree one bit—and I've said many, many times—that the problems of the thrifts drove the legislation; it would not have passed the last day of the session without that problem. I understand that and after 7,000 pages of testimony here, I think I understand the problem, and this year is different in all the respects you both outlined. But I still make the point very, very strongly that time on the floor is not the issue, because if it has not been put together in enough of a consensus, it simply will never go to the floor. If it has, it will pass very quickly. There will not be prolonged debate on the floor. If it's going to be a situation that's going to be out there for 1 week or 2, there is no point in taking it there because it will become so carved up that it would never go through conference, and you wouldn't produce a workable bill, and I wouldn't put it through the Senate.

So I don't disagree with either one of you. I just wanted to make sure you understood my point that I really don't think time or number of legislative days is important. The Senator from Michigan is correct, we may decide here we can do something, and if the general consensus on the floor is not there, it's not going to go to the floor. It just wouldn't be worth putting the 80-odd Senators through that.

Senator **Heinz**. Mr. Chairman, you're one of the greatest optimists of all time, and you're also a humanitarian, not to put the other 80-odd Senators to the test, but I don't know whether this is the kind of legislation that you can get a unanimous-consent agreement for, even if every single member of this committee desired it. So I don't want to take issue with my chairman. I just want to say that it is not entirely clear to this Senator that you can get this kind of legislation through the floor as easily as we got the legislation through last time, but I'm willing——

The CHAIRMAN. It wasn't easy.

Senator HEINZ. I'd like to defer further discussion of this in order to point out that the time in this committee is running short. The time is short and unless we get something agreed upon and reported by the middle or maybe arguably by the end of May, we're not going to be able to even get in line. We're not going to be able to get in line to get on the floor, even for 1 hour. The end of May is only a couple months away—April and May. So we have a very tight timetable and I hope the chairman—and I have discussed this with him—will as soon as possible set a markup date so we can at least focus members' minds on the fact that there are going to be votes on these issues, and unless we start focusing on that reality—and I know the chairman wants to do that—we will still be having this discussion in December, which is neither my nor the chairman's desire.

The CHAIRMAN. I would just assure the Senator that if I had my way we would have had a markup last summer. There will be no foot dragging on my part. I've been ready for a long time before we got 7,000 pages more of testimony. That's just about the timetable I've outlined since last fall of getting to a markup no later than May.

Senator HEINZ. Very well, Mr. Chairman.

Let me just ask Chairman Volcker—he is our witness I noticed.

The CHAIRMAN. You may have confused the heads, but he is the bald head with the cigar.

Senator HEINZ. Chairman Volcker, just a few specifics with respect to municipal revenue bonds which I gather you favor including as part of the package. Senator Hecht asked—or maybe it was Senator Mattingly who asked—whether that would improve competition, and you gave a soft answer to the question. You said there would be some reason to believe that it might.

Mr. VOLCKER. I think it will.

Senator HEINZ. Let me ask the question in a slightly different way just so it's all nailed down. Are you aware of any evidence of lack of competition in the selling and underwriting of municipal revenue bonds?

Mr. VOLCKER. As you know, there are many investment companies that engage in this activity. I think you might get a less certain answer as you got to some smaller issues in some regions of the country where big investment firms may not be familiar and not be active and not have the incentive to participate.

Senator HEINZ. So, to the extent that competition is not doing its job, it is likely to be found in rather smaller areas; is that correct?

Mr. VOLCKER. The problem might be more—I hate to use the word acute—more evident in outlying areas.

Senator HEINZ. All right. On mutual funds, which, I gather, you also believe need to be a part of a package permitting underwriting by banks—in any of the bills now before the committee—I'm thinking of S. 2181 and S. 2134—are there sufficient separate subsidiary anti-tie-in, anti-conflict-of-interest provisions that would satisfy you or do we have to go farther than any of the bills before us and, if we do have to go farther, how far do we have to go?

Mr. VOLCKER. There are some provisions in the proposed legislation about which we did raise some additional questions, some of which were raised by witnesses from those industries—for instance, about the name of the fund, to avoid confusion with the bank itself, about the separate officers and employees——

Senator HEINZ. Well, maybe I can make it easier. When you say other witnesses, you're referring to the Investment Company Institute and the Securities Industry Association?

Mr. VOLCKER. Yes.

Senator HEINZ. They had a list of 10 or 12 points.

Mr. VOLCKER. Yes.

Senator HEINZ. Are you saying that those points ought to be the basis for a separate subsidiary?

Mr. VOLCKER. I think those points certainly ought to be looked at. I don't want to endorse every last one of those points.

Senator HEINZ. Which ones don't you endorse?

Mr. VOLCKER. Could I give you that for the record?

Senator HEINZ. Fine. By all means. Let's do it that way.

[The following information was subsequently supplied for the record:]

COMMENTS ON SIA POINTS ON SECURITIES ACTIVITIES FOR BANK HOLDING COMPANIES

SIA Proposal

1. Only a separately capitalized, arm's-length subsidiary of a bank holding company ("securities affiliate") should be permitted to underwrite and trade in municipal revenue bonds (not including industrial revenue bonds or special assessment bonds).

Comment

This proposal is implemented by the provisions of S. 2181, S. 2134 and S. 1609, which require such activities to be performed in a separate securities affiliate. These bills also contain capital adequacy criteria and indicate that bank securities subsidiaries be no less adequately capitalized than their nonbank affiliated competitors.

SIA Proposal

2. The securities affiliate should be the only member of the bank holding company family to engage in securities activities.

Comment

This proposal is also implemented by S. 2181, S. 2134 and S. 1609. There are, however, a few traditional securities activities of banks that we do not believe it is necessary to transfer to the securities affiliate. These include the normal investment and funding functions of banks such as the purchasing and selling of investment securities for a bank's own account, the provision of custodial and transfer agent services, private placement advisory services, and trust services. The desirability of retaining such traditional activities within banks has been recognized in each of the bills mentioned above.

SIA Proposal

3. No member of the bank holding company complex should be allowed to use its assets or business relationships to assist the securities affiliate in its securities activities.

Comment

The present limitations contained in section 23A of the Federal Reserve Act and the proposed new section 23B contained in S. 2181, S. 2134 and S. 1609 accomplish the objectives of this proposal by strictly limiting transactions between a bank and its securities affiliate and requiring that any remaining permitted transactions be on market terms. In addition, banks in their relationships with their holding companies are subject to anti-tying prohibitions that are not applicable to securities firms.

SIA Proposal

4. Deposits should be completely insulated from the risks assumed by a securities affiliate and should not directly or indirectly become of benefit to a securities affiliate.

Comment

This proposal is also implemented by the requirement in S. 2181, S. 2134 and S. 1609 for a separate affiliate for the conduct of securities activities. It is similarly supported, as noted above, by the limitations of section 23A and the proposed new section 23B of the Federal Reserve Act. Also as noted above, a securities affiliate would be separately and adequately capitalized in order to prevent any assertion the bank should be responsible for the obligations of its securities affiliates.

SIA Proposal

5. The tax treatment of securities affiliates and of banks which are allowed to continue securities activities should be identical to that of broker-dealers and should be

provided for specifically in any proposed legislation dealing with these matters.

Comment

It is implicit in the separate subsidiary concept for securities affiliates that those affiliates would be subject to the same tax treatment as other securities firms.

SIA Proposal

6. - 8. These three proposals deal with guarantees of customer obligations, information sharing, and name identification. Specifically SIA proposed:

A. The BHC Act should be amended to forbid a securities affiliate from participating in a financing in which any member of the bank holding company complex is participating (e.g., as a supplier of a letter of credit or short term financing or acting as bond trustee), and vice-versa.

B. If the securities affiliate is to operate under its own authority and by its own skill it should not benefit from customer and other valuable data constantly flowing into and developed by its affiliated banks.

C. A securities affiliate should not be permitted to trade on identification with the bank holding company complex.

Comment

These proposals are not now implemented in S. 2181, S. 2134, and S. 1609. It is not clear that such prohibitions are needed in the light of the other limitations in the proposed bills on inter-corporate transaction and on tying. Nevertheless, a cautious approach in this area is justified and a number of suggestions proposed by others to assure competitive equity and avoid conflicts deserve attention.

Thus, it may be reasonable to prohibit a bank holding company's securities or investment company affiliate from using the name of an affiliated bank or bank holding company (in the interest of appropriate disclosure, an indication of company affiliation should be permissible). The Garn, Proxmire and Treasury bills contain provisions prohibiting a bank and its affiliates from using advertisements suggesting that the bank is in any way responsible for the obligations of its affiliates, and we support such a provision. It may also be desirable to require that the officers and employees of a securities affiliate or investment company advisor be separate from those that operate an affiliated bank, and that information on the financial activities of the bank's customers not be made available to the securities affiliate and vice versa. Banks might be limited in guaranteeing or providing letters of credit to support obligations that are underwritten by a securities affiliate.

It may be desirable, however, to grant the Federal Reserve some authority to exempt smaller banking organizations from the prohibitions regarding officer interlocks in order to allow them to engage in securities activities efficiently, subject to appropriate rules, to assure that the objectives of the otherwise applicable limitations were maintained. Such exemptive authority for smaller banks should be coupled with related power to provide exemptions from the types of limitations discussed above to ensure competitive equality with financial services conglomerates other than bank holding companies which may engage in explicit or implicit tying of the various financial products they offer.

It also may be appropriate, as SIA has suggested, to prevent a securities affiliate from sharing premises with its affiliated banks, although we do not believe it would be necessary for such a prohibition to extend to the sharing of premises between the securities affiliate and other holding company subsidiaries. It has been the Board's policy that all subsidiaries of a bank holding company should bear their own costs and expenses, and we believe that an absolute prohibition on sharing office space with other holding company subsidiaries is unnecessary.

SIA Proposal

9. If new underwriting powers are to be granted to bank holding companies or banks, appropriate powers in the field of banking should be granted to securities firms.

Comment

The provisions of the Garn, Proxmire and Treasury bills would, consistent with the policies and objectives of the Bank Holding Company Act, allow securities firms engaged in mutual fund, securities, brokerage activities, and in mortgaged backed securities to acquire banks and become bank holding companies. However, SIA has suggested that if bank holding companies are to be permitted to engage in this limited scope of securities activities, then all securities organizations (apparently including underwriters of corporate securities) should be permitted to engage in banking operations. In order to take this step, Congress would have to conclude that it would be consistent with the purposes of the Bank Holding Company Act for banks to be affiliated with securities underwriters. Our conclusion is that it would not be appropriate or consistent with the Act to permit the affiliation of banking organizations with underwriters of corporate securities.

SIA Proposal

10. A carefully phased timetable for institution for any such changes should be worked out in the interest of stability.

Comment

The approach to these issues contained in the Garn, Proxmire and Treasury bills is a limited revision of existing laws that has been under consideration for more than two years. It does not appear that such a phase-in period is necessary.

NO GRANDFATHERING CONCERNING DIVESTITURE

With respect to divestiture, you made a very strong statement. You have essentially said that there ought to be no grandfathering and——

Mr. **Volcker**. This again depends upon the kind of bill. I think that with a broad bill—and this can't be judged until the end of the process—the grandfathering provision that Senator Garn had in his bill might be adequate. If the bill is sufficiently strong, the problem doesn't arise as acutely. If there were a retreat to a very narrow bill which redefined a bank—and I'm not advocating this—and redefined a thrift and said no new powers, then I think equity would require a rollback among those institutions that have reached those lines already.

Senator **Heinz**. I guess the first definition of bank and S&L bills were introduced in the course of the last year, in 1983.

Mr. **Volcker**. Yes.

Senator **Heinz**. If you made the assumption—and this is a hypothetical question—if you made the assumption that we had a limited bill as you describe, that we should not grandfather much past the point when those bills were introduced in order to send a message to people?

Mr. **Volcker**. I'm not even sure in those circumstances, whether you should grandfather arrangements made before those bills were introduced.

Senator **Heinz**. Even if it's a narrow bill?

Mr. **Volcker**. If it is a very narrow bill. The narrower the bill, the less degree of grandfathering, it seems to me.

Senator **Heinz**. The narrower the bill, the more people will want to be grandfathered.

Mr. **Volcker**. The more people will want to be grandfathered and the less they will deserve it.

If the bill is broad enough, I don't think it's going to be a difficult problem.

Senator **Heinz**. Right.

Last, I get the sense—well, let me ask you this. When I came into the hearing you were finishing a part of your statement. It was just before you said, "Now turning to page 27 or 28," and you said something about powers not necessarily essential to the bill and you had been talking about insurance and I wasn't sure whether that was about insurance or about powers generally.

Mr. **Volcker**. I don't remember saying it at that point, but I can only repeat my response to Senator Riegle a little while ago, when he was pressing me on what's essential and what isn't essential. I think it is essential, as kind of a conceptual core of the bill, to have a definition of banking, a definition of thrifts. I don't think there's much concern about the regulatory streamlining.

I think it is also, from my point of view, essential that you have some broadening of powers. But when it comes to an individual power, I can't argue that the bill is going to rise or fall on every specific power provided. Clearly, that's saying too much.

Senator **Heinz**. Well, what you're saying is now is the time to make a permanent comprehensive definition of what a bank and S&L are.

Mr. **Volcker**. Yes. I think that's the starting point.

Senator **Heinz**. That's really what you're arguing for?

Mr. **Volcker**. That is the starting point, but then I think you have to move beyond that and say now that we've got that clarified, what can a bank holding company or a thrift holding company logically do and what can't it do.

Senator **Heinz**. Now in the Fed bill you proposed basically three things—the municipal revenue bonds, the mortgage-backed securities, and mutual funds. How financially important are those to banks?

Mr. **Volcker**. Let me say that we haven't got a bill. We supported——

Senator **Heinz**. I'm sorry. I misspoke.

Mr. **Volcker**. We supported the administration approach which is pretty well incorporated in——

Senator **Heinz**. Do you support Senator Proxmire's bill?

Mr. **Volcker**. We support Senator Proxmire's bill—I'm not talking about every last provision—as far as it goes, but we would like to see it broader than that.

Senator **Heinz**. Taking that as an example of several powers that we might decide to grant here to banks, how financially important are those powers to banks? Banks account for $2.3 trillion of assets. What do municipal revenue bonds account for?

Mr. **Volcker**. For most banks it would make very little or no difference.

Senator **Heinz**. What about mutual funds? Are most banks going to get into the mutual fund business?

Mr. **Volcker**. I assume that a great majority of the 14,000 banks will not.

Senator **Heinz**. And the characteristics of mutual funds are such that they have to be sold interstate?

Mr. **Volcker**. I don't know if they have to be, but they probably come under the FTC restriction if they are.

Senator **Heinz**. They would have to be?

Mr. **Volcker**. For all practical purposes, they are sold interstate. Many small banks are not going to be interested, I'm sure, in setting up a mutual fund. There may be some that think they have some expertise or marketing advantages in this area that may make it worthwhile, and they ought to have that option.

Senator **Heinz**. Let me ask you this bottom line question. Would it be a fair characterization of your view that what we're really talking about here is, in order to clearly define what a bank is, in order to clearly define what an S&L is, what we need to do, in addition to that, is get a set of powers in the bill that will be of sufficient weight to pass the bill?

Mr. **Volcker**. I think there is that aspect, but I think that is related to the underlying economic reality that you will not resolve these issues without banks, bank holding companies, and their competitors feeling that you've got something they can live with over a period of time. I think that is related to the ability to pass the bill but it's not quite the same thing.

Senator **Heinz**. Thank you very much, Chairman Volcker.

The **Chairman**. Senator Riegle, I believe you had another question.

Senator **Riegle**. If I may. Just on another subject because it's important and it relates to other work that we're involved in on the budget and so forth.

On the Argentina story today about them not making their current payment and the need for banks to reclassify these loans unless—the Argentines have announced their position so I gather that's what the banks are going to be faced with—as you look at the international——

PROGRESS MADE IN ARGENTINE SITUATION

Mr. **Volcker**. If I may just clarify that, I don't think it's the position of Argentina that they in any sense want to pass this date. I think the negotiations are at a stage where the possibility that it be passed without interest payments is indeed a possibility. But I feel somewhat more encouraged about the progress of the situation, more fundamentally today than I did a few weeks ago, because there are active negotiations and efforts to deal with the problem underway.

I think we have to be conscious of the fact that Argentina has a new government with many urgent priorities at home, as well as their debt problem, which I consider and I believe they consider urgent as well, but we have run into a situation where competing priorities have been a problem in terms of timing.

Senator **Riegle**. Well, I think what you say is important here and I'm glad you feel somewhat more optimistic than you did a few weeks ago and the talks are going forward and there are some efforts being made here.

Assuming for the moment that they pass the date and resolution isn't found and the banks have to reclassify and so forth.

I'm wondering, are there other problem situations out there? Let's leave Argentina aside for the moment. Are there other situations that we should be paying attention to that may be developing along the same lines?

Mr. VOLCKER. I don't know of any quite like Argentina. As you well know, there are other problem situations out there in varying degrees of resolution: some of them quite far advanced and about which we can, I think, legitimately be more optimistic; some kind of in midstream, in terms of the adjustment programs underway; and others in a still earlier stage.

Senator RIEGLE. I think there's a tendency for there not to be a great amount of attention paid to the foreign debt problem until suddenly a red flag goes up, and I guess what I would ask you, leaving Argentina aside and taking the rest of the problem situations, would it be fair to say that all of them are moving forward quite nicely and things are falling into place properly and that we're really coming out of the woods, or would it be more accurate to say that it's a mixed picture and that there are still some serious problems and we don't have a self-solving problem and we don't have to worry about it?

Mr. VOLCKER. We certainly don't have a self-solving problem and it's certainly a mixed picture, but there are elements of encouragement.

To some degree, psychologically or otherwise, the success in one country begets success elsewhere; lack of success may have adverse consequences on other countries too. It's all interrelated.

As your earlier colloquy made quite clear, we're living in a world where people apparently respond to red flags up or down. I don't see the situation as one that a red flag is up this month and it's all clear sailing next month. It's a continuing, large problem and it's going to continue to be.

Senator RIEGLE. Is there another Argentina that is not in as severe a shape but is the next worst problem that may not be far behind here? Is there a specific country with its own set of problems moving in that direction?

Mr. VOLCKER. There are a dozen countries or more that have severe external debt problems that are in varying stages of resolution. They may undertake a program with the Fund and make arrangements with the banks and then see how the success of that program goes, and then reach another point maybe a year later where they have to look forward to the next year's programing of funds with the IMF and get some more financing. All of those are checkpoints, and innumerable problems can arise at each of those checkpoints.

Senator RIEGLE. I take it then that we don't see at the moment any other country that's likely to move into a nonperforming status within the next several weeks or the next 2 or 3 months?

Mr. VOLCKER. We have some small countries that have been in that status for a long time, but no other major countries, no.

Senator RIEGLE. Thank you.

The CHAIRMAN. Mr. Chairman, I want to just sum up and respond to Senator Heinz' comment about greed.

I don't disagree with him. I've made too many speeches around the country, particularly in reference to the October-November-December period of 1981 where I said I had never had such an education in greed in my life. In the initial hearings, everybody wanted what benefited them and to heck with everybody else and I don't disagree that the motivation by a lot of different organizations and groups is their profit motivation.

COMPETITIVE EQUITY IS THE REAL ISSUE

But I also feel very strongly and what has motivated me in this whole process over the last 3 or 4 years is that competitive equity is an issue.

Mr. VOLCKER. There's no question.

The CHAIRMAN. And I think that is a prime issue of what Government is doing. If people play by the same rules and they can put another competitor out of business and make more money, so be it. But if it is Government that is defining the playing ground and denying some people access to markets—I don't disagree with the characterization in many places that competitive equity is the big issue here, and there is not a crisis as there was concerning the thrifts. It's more of a gradually growing problem of great inequities out there due to technology and other factors that are going on in the marketplace that will change whether we do anything or not.

So I still very strongly believe that a broad bill is needed this year. How broad is broad remains to be seen. I think that's highly important.

Somebody said in one of the hearings a couple of weeks ago that new legislation is hard to digest and I agree, but I think the aberrations of the marketplace, State legislatures, regulators, and so on are a lot more difficult for the marketplace to digest than having some national policy set, whatever that national policy is, that they know they can depend on and know what the rules are and, again, more competitive equity in the marketplace because there certainly is not here, and the greed factor works. There are some who when they come before this committee and testify that they want legislation, I question their sincerity because the greed factor works in the marketplace to those who have advantages because of what Government is doing or not doing as well.

I think at least as far as the committee and as far as my motivation is concerned, that we are trying to achieve some level of competitive equity, and the longer we defer those decisions, I think the much more difficult it becomes to achieve that.

Mr. VOLCKER. If I may respond just very briefly, Mr. Chairman, you've articulated much better than I succeeded in doing why I think you need a broad bill, and I think you have put that aspect of it exactly right.

But let me also say that I don't think it's just a question of competitive equity. Underlying all this ought to be the safety and soundness of the banking system. And while there's no crisis—things are not going to collapse overnight—I can well visualize the day a few years from now, if we don't act and all the States go their own way and all the loopholes are exploited, when we'll be back here and we will have a great crisis. And you're going to say, "Where was the Federal Reserve?" And we're going to say, "Well, we didn't have any authority or power to deal with this situation. We didn't like all this business in connection with industrial firms and banks and all the conflicts of interest they were getting into, but we didn't have the tools to react to them."

There are no limitations on real estate development in all these State laws, and they raise hazards for big and small institutions, but how are we going to deal with them? You didn't give us the authority to deal with them. I want to put you on a little bit of notice that I think we need some of these authorities or you will have—not just what you're talking about, which is very relevant—but we should be walking into—cultivating the garden in a future crisis.

The **CHAIRMAN**. Believe me, I hated to have to operate and function in that type of crisis attitude in 1981 and 1982 and, unfortunately, too many times it takes a crisis to get Congress to act in this or any other field. I'm afraid that's going to be true with the budget deficits too. It's going to have to get worse before we finally come to grips with that. That's why when some people said, "Hey, we just got one broad bill passed. Why don't you relax for a while?" The whole point of what I've been trying to do is to get Congress to act and say, "Hey, there will be a crisis. I don't know whether it will be 1, 2, or 5 years down the road, but there will be one." So for once, why don't we act? Why this fear of making some decisions before you get to a crisis?

I frankly don't understand. So I just emphasize in closing that I still feel there is a need, a great need, for a broad bill and, please, let's not wait until we get into a crisis when we will then say, "Hey, we enacted another bill because we had no other choice but to do so because the marketplace was in such great difficult straits."

We appreciate once again your testimony and we appreciate the detail of it with the appendixes that you have with it.

Tomorrow we will hear our concluding witness in this series of hearings, Secretary of the Treasury Regan.

Thank you very much for coming.

The committee is adjourned.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

COMPETITIVE EQUITY IN THE FINANCIAL SERVICES INDUSTRY

PART III

WEDNESDAY, MARCH 28, 1984

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Tower, Heinz, Gorton, Hecht, Riegle, and Lautenberg.

OPENING REMARKS OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Mr. Secretary, we are very happy to have you before us today for the concluding hearing in this series of hearings on the Competitive Equity Act.

I just turned to Senator Tower and asked him if he had an opening statement and he said yes, and I said I didn't; after 7,000 pages of testimony, I definitely didn't. But before we turn to you, I'm very pleased to turn to my distinguished senior colleague on this committee, Senator John Tower.

OPENING STATEMENT OF SENATOR TOWER

Senator TOWER. Thank you, Mr. Chairman.

Mr. Secretary, as you're aware, Senators Garn, Proxmire, and I are very interested in broadening the secondary mortgage market for home mortgages.

Last August, we introduced two bills that had this goal as their thrust, S. 2040 which passed the Senate last November, and S. 1822 which is our version of Trust for Investment in Mortgages [TIM's], which has been referred to the Finance Committee and has had 1 day of hearings.

Since last August we have patiently waited for the Department of the Treasury to introduce their version of TIM's. Your witness, Mr. Woodward, told the Finance Committee on November 4 of last year that the administration would be introducing legislation in the near future. Both tax committees have told me they want an administration proposal and revenue estimate before they begin serious consideration of this bill.

Mr. Secretary, I would urge you as chairman of the Cabinet Council on Economic Affairs to complete your internal review and forward a proposal. In my view from a business perspective, TIM's is a preferable vehicle for securitizing mortgages by the private sector than is the collateralized mortgage obligation or CMO.

I believe the Senate and House Tax Committees can work out an appropriate legislative compromise that will accomplish two chief goals: (1) utilize TIM's to encourage more participation in the secondary market by the private sector and thus assist both home buyers and the credit markets and (2) limit the scope of participation by the Government agencies to only that role which will not encumber the fostering of the new private sector.

So we would like to see some movement on this, Mr. Secretary.

Thank you, Mr. Chairman.

The **Chairman**. I might just add, Mr. Secretary, that I cosponsored these bills with Senator Tower and although there is some talk going around that the marketplace has passed a TIM's proposal by, that it is no longer necessary, certainly John and I do not agree with that. We think it is important that we proceed along those lines.

Mr. Secretary, we are pleased to have you with us, if you would proceed.

STATEMENT OF DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary **Regan**. Thank you, Mr. Chairman. After I read my opening statement I'd be more than happy to respond to the concern of Senator Tower and yourself, Mr. Chairman.

Mr. Chairman, members of this distinguished committee: 2 months ago I appeared before you in Salt Lake City to present the administration's preliminary views on the pending proposals to deregulate the financial services industry.

Since then, you've heard from the affected industries, Federal and State regulators, and the academic community.

Mr. Chairman, your leadership in this important issue is critical. Your efforts to secure passage of the Garn-St Germain Depository Institutions Act of 1982 will be long remembered and appreciated. The resulting legislation from these hearings should be just as important and just as historic.

At the outset, let me impress upon you the urgency of the situation facing the Congress. You are all aware of the well-documented entry into the once forbidden ground by Sears Roebuck, Merrill Lynch, E. F. Hutton, American Express, and Prudential. Mr. Chairman, these are not the only clever firms which are taking advantage of the statutory inconsistencies of the Federal law. The boards on the wall give examples of other companies all of which own banks. These range from 3M to Macy's. All of these companies have one important thing in common; none are banks, yet each owns one.

[The following charts were submitted for the record:]

EXAMPLES OF
COMPANIES WHICH OWN BANKS
BUT WHICH ARE NOT BANKS

J. C. PENNEY
(Retailing)

TRAVELERS
(Insurance)

MERRILL LYNCH
(Securities)

GULF & WESTERN
(Communications)

BENEFICIAL CORP.
(Financial Services)

3M
(Manufacturing)

PRUDENTIAL-BACHE
(Securities)

MACY'S
(Retailing)

DREYFUS CORP.
(Mutual Fund)

AVCO CORP.
(Financial Services)

CONTROL DATA
(Data Processing)

SHEARSON/AMERICAN EXPRESS
(Securities)

ÆTNA LIFE & CASUALTY
(Insurance)

HOUSEHOLD
(Financial Services)

E. F. HUTTON
(Securities)

MC MAHAN VALLEY STORES
(Retailing)

EATON VANCE CORP.
(Mutual Fund)

MARSH & MC LENNAN
(Insurance)

TEACHERS SERVICES ORGANIZATION
(Consumer Credit)

FIDELITY
(Mutual Fund)

NEW ENGLAND MUTUAL
(Insurance)

BRADFORD NATIONAL CORP.
(Financial Services)

PRESENT LAWS ARE UNFAIR TO BANKS

Secretary **Regan**. We do not object to aggressive nonbank or nonthrift firms offering new products to consumers and increasing competition in the market for financial services. In fact, we endorse the concept of aggressive competition in serving consumers. We are concerned, however, by laws that unduly restrict the ability of bank or thrift holding companies to meet their diversified new competitors. This is unfair to these firms. It's unfair to consumers who would benefit from greater competition if such laws were reformed.

As these diversified financial services firms cause changes in the marketplace, the States have begun to alter their banking laws in order to gain new jobs, preserve old ones, and allow their banks to compete. South Dakota's insurance law is well known, but California, Florida, and North Carolina have also recently enacted laws to allow banks into new activities. The Ohio Senate passed such legislation just 3 weeks ago. And as you know, last month, a New York commission proposed that New York banks be allowed to engage directly or through a subsidiary in insurance underwriting and brokerage. New York's attitude is best summed up by its banking superintendent who recently stated: "Financial services is to New York what high tech is to California and we won't remain idle while other States grab our institutions."

Action by New York, the home of some of our largest banks, would probably provoke a bidding war among the States. But States aren't the only problem. We also see numerous examples of Federal regulators and courts that by their actions are beginning to set the direction and tone of deregulation.

The combination of these factors will produce a chaotic system which may shortly proceed beyond the power of Congress to retrieve. Federal regulators are going to be unable to stop State-chartered banks from taking advantage of permissive State laws. The burden rests with Congress.

Mr. Chairman, I submit to you that all this is happening because the regulators, the State governments, courts, financial, and nonfinancial companies are rushing to fill the void created by congressional inaction. By allowing the industry to continue restructuring itself, Congress loses its opportunity for meaningful reform.

I appreciate that we are here today precisely for these reasons. I urge you not to be derailed by self-serving arguments of selfish interest groups.

THE CONSUMER AND DEREGULATION

I believe the disarray and dangers stemming from this haphazard de facto deregulation is clear. It should be equally clear that the industry would benefit from the orderly and sound deregulation promoted by congressional legislation. So, today, I'd like to stress the benefits for consumers.

As a result of interest rate deregulation, savers are already receiving market rates of interest on their investments, large or small, in a variety of deposit accounts. And as a result of increased competition in this deregulated environment, consumers will benefit from a wider variety of services at lower prices and the convenience and efficiency of one-stop shopping.

We see many examples of this already. Today, there are more than 1,000 banks and thrifts in discount brokerage. Some combine this service with insured deposits to offer full central asset accounts. Others experiment with insurance and real estate agents working out of bank branches. To speculate about a nationwide financial services supermarket is not fanciful; it's reality. You have only to look at Sears for proof that consumers are responding enthusiastically to this innovation.

NONBANKING DEREGULATION

The experience in industries other than banking also demonstrates there are clear economic benefits to deregulation, especially for consumers. Deregulation of both the airline and trucking industry has stimulated competition and provided consumers with a wider choice of services at lower prices. Indeed, long-distance airline fares have declined 50 percent in constant dollars over the last 7 years.

THE GARN BILL

I will focus the remainder of my remarks on the Garn bill which is basically consistent with the administration's proposal made last summer. I am particularly pleased that it adopts the holding company approach which insulates depositories from undue risks and prevents unfair use of their cost-of-funds advantage. It will lessen regulatory disparities by requiring that nonbanking activities be conducted in a separate affiliate subject to the same regulations as others in the same industry.

There are two issues in the Garn bill I'd like to address specifically—consumer banks and the qualified thrift lender test. I've submitted for the record our views on these issues in greater detail but I will summarize our position.

CONSUMER BANKS

In January, I noted that the administration had not yet taken a final position on the consumer bank issue. There is some real appeal to the concept of eliminating completely the regulation of holding companies for depository institutions, which is the effect of authorizing a consumer bank. However, we have not heard persuasive reasons for some to get into the banking business through consumer banks while remaining unregulated. We remain concerned about the competitive inequity that would result.

QUALIFIED THRIFT LENDERS

The administration is not opposed to a qualified thrift lender exemption. However, in the interest of competitive equity, the exemption should be kept as narrow as possible and be tied quite tightly to residential real estate lending. So far, we've heard no persuasive argument that S&L holding companies should be treated more favorably than the holding companies of commercial banks unless they contribute substantially to investment in residential housing.

TRADE ASSOCIATION COMMENTS

I will now turn to the positions and statements of those groups which have testified in opposition to the Garn bill. Specifically, I'd like to highlight the inconsistencies of their arguments.

Analyzing the opposition's statements made before this committee on the deregulation issue, we found one central theme—I've got mine; I want yours; you can't have mine. This is a counterproductive and even dangerous philosophy.

SECURITIES INDUSTRY

The securities industry, for example, is outraged by the regulatory restrictions on brokered deposits, citing the benefits consumers receive from this new service. Brokered deposits are significant because they give the securities industry access for the first time to consumers' savings. They've always had access to consumers' investment funds. But when proposals are made to permit bank holding companies to compete with them for investment funds, the securities industry cries, foul.

The securities industry argues further that banks would stuff securities into trust accounts or bank portfolios if permitted to engage in securities underwriting. If such a danger exists, it applies as well to securities firms that have discretionary accounts, manage investment companies, or are affiliated with insurance companies.

Of course, there are laws which prohibit stuffing of customers' accounts. That's just the point. The problem is handled by regulating the abusive transaction, not by prohibiting the affiliation. Imagine the outcry from the securities industry if affiliations between securities underwriters and investment managers of large institutional investors such as insurance companies were restricted.

INSURANCE INDUSTRY

The insurance industry questions whether the holding company requirement adequately insulates depositories and whether the proposed antitying provisions or indeed any tying restrictions can protect their industry from unfair competition. It's disingenuous for the insurance industry to argue that soundness of banks would be jeopardized by affiliations with firms engaged in nonbanking activities when they do not make the same argument concerning potential hazards to the insurance companies' safety from affiliation with other organizations.

Insurance agents and underwriters argue that the combination of lending and insurance agency powers creates the danger of anticompetitive tying. If this is so, why is it not also a problem when insurance companies act as lenders? Moreover, at least two major insurance companies, Prudential and Allstate, are already affiliated with depository institutions through holding companies without any allegations of tying.

Finally, we believe these arguments fail to acknowledge the Garn bill's proposed new restrictions on tying and the benefits to consumers of permitting new activities subject to regulations as an alternative to absolute prohibition. The administration supports the stronger antitying provisions of the Garn bill and my prepared statement suggests that we're willing to listen to additional useful measures.

REAL ESTATE INDUSTRY

The real estate industry cites tying concerns in opposing banks' new real estate brokerage development powers. Yet, with the advent of a national mortgage market in which home buyers have access to mortgage lending outside their localities through computerized networks, realtors have begun to form affiliations with mortgage brokers. Indeed, S&L's and banks are beginning to claim that realtors are freezing them out of mortgage lending because of the tie-ins with mortgage brokers and other participants in this national mortgage market.

Instead of creating loopholes to expand their own activities and contriving arguments to keep banks and thrifts out of their business, we think the securities, insurance, and real estate industries could put their creative efforts to better use by putting deregulation to work for them.

Opponents of deregulation would do well to consider the potential opportunities that will arise from direct affiliation with banks and S&L's allowed under the Garn bill.

CONCLUSION

In conclusion, I have reviewed in some detail the inconsistencies in the opponents' arguments because it's vital for this committee to understand that we are dealing not with real issues of public policy but with simple protection of competitive turf. The Garn bill represents good public policy. The Federal regulators and the administration have reached a consensus that enactment of the Garn bill is in the best interests of consumers and the financial system.

The bill would first resolve many of the present anomalies and inconsistencies in current regulation. Second, provide a legal framework in which insurance companies, securities firms and others could safely affiliate with depository institutions. Third, give holding companies new powers to compete and bring benefits to consumers. Finally, create a framework for equal, fair competition in the future.

Congress, as I see it, has three choices. First, you can continue to do nothing and allow the loophole lawyers, the marketplace, the States, and the Federal regulators to mold the financial services industry as they see fit. The framework they will enact will be inconsistent, inefficient, and less effective in the use of services delivered to consumers.

Second, you can turn back the hands of time and force the divestiture of banks owned by the companies you see on the wall and others, a total of 54 by one count.

Third, you could enact legislation which will respond to the realities of the marketplace and put in place a structure which will preserve the integrity of our Nation's depository institutions while fostering competition.

Mr. Chairman, I believe that you and the other members of the committee and I are in agreement that the third choice is the only acceptable one. I, therefore, urge you to move immediately. Everyone is watching and waiting for signs from you and your committee. The strongest message you can send is to proceed without delay with the markup of S. 2181.

Mr. Chairman, that concludes my testimony. I will be pleased to answer any questions the committee may have.

[The complete statement follows:]

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Testimony
# of the
Honorable Donald T. Regan
Secretary of the Treasury
before the
Senate Committee on Banking, Housing and Urban Affairs

Mr. Chairman and members of this distinguished Committee:

Two months ago I appeared before you to present the Administration's preliminary views on the pending proposals to deregulate the financial services industry -- the Administration's Financial Institutions Deregulation Act (S. 1609, "FIDA"), Senator Garn's Financial Services Competitive Equity Act (S. 2181, "Garn bill") and Senator Proxmire's Depository Institutions Holding Company Act Amendments of 1983 (S. 2134). Since those introductory hearings in Salt Lake City, you have heard from representatives of all of the affected industries, the Federal and state regulators, and the academic community. It is a pleasure to have this opportunity to assess their views and to be able to stress once again the urgent need for action in 1984.

I would like to emphasize three themes in particular:

-- First, the likelihood that, unless Congress acts, a combination of state legislation and creative lawyers will cause permanent fragmentation of the financial system.

-- Second, the benefits to consumers and the competitive equity that will result from increased holding company powers and a new legal framework for the financial services industry.

-- Third, the inconsistency of the theories upon which opponents of deregulation have been relying.

THE NEED FOR HOLDING COMPANY DEREGULATION

Disarray in the marketplace. Until very recently, the activities of banks, thrifts, investment banks, insurance underwriters, and securities brokers were all separate and clearly defined. However, under the competitive pressures of today's financial services marketplace, the old structure is breaking down, thus creating inequities in the system and regulatory disarray. The number and type of direct competitors to depository institutions has increased dramatically. Unregulated financial services firms have responded innovatively and rapidly to market changes, offering consumers effective substitutes for traditional banking services as well as other financial services that banks by law or regulation are forbidden to offer. Today there is virtually no major bank or thrift-like product that is not available from a diversified financial services firm, and there is no bank or bank holding company that can offer the range of services that more sophisticated consumers are demanding from their financial intermediaries.

Because many nonbanking firms are successfully soliciting the more attractive and profitable aspects of traditional banking business, banks must compete with these firms for customers while they are unable because of regulatory restrictions to offer the range of services these customers demand.

There are many examples of this challenge, and every day seems to bring news of further erosion of traditional lines of business:

-- Sears, Roebuck offers the equivalent of banking (through a savings and loan association), insurance and securities underwriting, mortgage banking, and insurance, securities and real estate brokerage.

-- Prudential Life Insurance Company not only offers securities brokerage through Prudential-Bache, but has acquired a nonbank bank. Merrill Lynch, Aetna, and other financial service firms are also attempting to form nonbank banks.

-- American Express Company, which already owns Shearson/American Express and Boston Safe Deposit Trust Company, has acquired most of the assets of Alleghany Corporation, including Investors Diversified Services, which offers insurance, investment products, and mutual funds.

-- Fidelity Group is distributing its mutual funds through five banks.

-- Securities firms and at least one discount store are brokering Federally-insured certificates of deposit.

-- Insurance companies and securities firms have announced their intentions to sell their products through banks.

Meanwhile banks and their holding companies have not been standing still. Even though they operate under restrictive laws, these institutions have been pressing against the limits set on their activities in order to broaden their access to customers.

-- BankAmerica has moved into the insurance business by announcing it will allow Capital Holding Company, a Louisville-based firm, to sell insurance in its branches.

-- Citicorp now operates S&Ls in California, Florida, and Illinois.

-- Many banks, bank holding companies and S&Ls offer discount brokerage services, and national banks have also been permitted to offer investment advice.

-- The FDIC has proposed a rule that would allow nonmember banks to engage in limited corporate underwriting through subsidiaries.

Congress must set the rules that will apply today as well as establish a framework that will accommodate market dynamics in the future. By doing nothing, Congress makes a very unwise decision -- to endorse haphazard and chaotic deregulation by court interpretations of existing laws that were not meant to cope with a new economic environment, by actions of states anxious to assist their depository institutions and attract jobs, and by the Federal regulators. Moreover, consumer demand for innovative services and greater convenience will not abate. Competitive pressures fed by consumer demand will continue to create upheaval in the marketplace unless a structure is adopted to rationalize it.

Statutory loopholes. The statutory loopholes the market has been exploiting are well known. Nonbank banks may avoid the Bank Holding Company Act's separation of banking and commerce and restrictions on interstate banking by foregoing demand deposits or commercial loans. Recently, a court ruled that an industrial bank that offers NOW accounts is not taking demand deposits (First Bancorporation v. Board of Governors, the so-called "Beehive" case).

This ruling suggests that it may be possible for firms engaged in any line of business to acquire a depository institution that offers transaction accounts to consumers without becoming subject to the Bank Holding Company Act.

Unitary thrift holding companies may engage in virtually unlimited activities if their assets are sufficiently concentrated in housing-related loans, even though thrifts now have asset and liability powers substantially equivalent to those of banks. Federally-chartered S&L service corporations are permitted to engage in a wide range of activities, notwithstanding the potentially greater risks to the Federal insurance fund -- and ultimately public taxpayers -- of their engaging in nonthrift activities. State S&Ls and nonmember banks can conduct unlimited securities activities through subsidiaries and affiliates to the extent permitted by state law and deposit insurance regulations. Finally, the dual banking system gives states the freedom to determine the activities their banks and bank operating subsidiaries may conduct.

State actions. Recent state actions underscore the potential impact of state banking activities on the nation's financial system. Last month, a temporary New York state commission proposed that, beginning on January 1, 1985, New York banks be authorized to engage in insurance brokerage activities directly or through subsidiaries. It also recommended that New York banks be permitted through holding companies to underwrite both life and property and casualty insurance. The report stated that if Congress fails to enact legislation permitting bank holding companies to engage in insurance underwriting, New York banks should be authorized to do so directly. Enactment of legislation adopting these recommendations would be a watershed event for the financial services industry. Because interstate banking restrictions probably would not limit the ability of New York banks to expand their insurance operations geographically, these banks would gain a competitive advantage over banks in other states. The resulting competition between the states would intensify the pressure for greater asset powers and less regulation.

There are many other examples of deregulation at the state level. At least four states explicitly authorize securities activities broader than discount brokerage. At least three permit real estate development, seven operation of travel agencies, and eight data processing. Banks in at least three states -- California, Massachusetts, and North Carolina -- can invest all or a specified part of their capital or assets in virtually any activity they wish.

States are motivated to expand the permissible activities of the banks they charter by the prospect of new business and more jobs, the competitive threat their banks face from deregulation in other states, and the risk of losing their institutions to more permissive jurisdictions. The New York State Bank Superintendent expressed the flavor of the states' concerns when he said recently: "Financial services is to New York what high tech is to California, and we won't remain idle while other states grab our institutions."

Spurred by banks' concerns over their competitive position, this trend to grant nonbanking powers to banks under state law is accelerating, and it will continue until Congress acts. We oppose this method of deregulating banks because it will enable banks to get into nonbanking activities directly and not through holding companies. But it is far from clear that Federal regulators have the legal authority to stop state-chartered banks, even those in holding companies, from taking up these new powers. If they do not, deregulation will have come in the least desirable way -- through a bidding war between the states. A chaotic situation will develop which Congress could rectify only over the strong opposition of the states as well as the banks. Industries which now oppose the limited entry by bank holding companies into their business would find themselves competing directly with banks themselves, whose use of Federally-guaranteed funds in the course of this competition would create wholly new inequalities in the offering of financial services.

Thus far, if their testimony on S. 2181 is any guide, the industries into which state-chartered banks will expand are blissfully unaware of what may await them. Instead of seeking constructive legislation at the Federal level, they seem to prefer to take their chances -- against all evidence -- that the states will not act or, if they do, that the Federal bank regulators or the courts will step in. This is a considerable gamble, and one I think they will lose.

Risk of delay. The longer Congress delays action on a holding company deregulation bill, the more its problems will be compounded. Because of inaction, new structures in the financial services industry may become so entrenched as to be politically irreversible. This will be especially the case as states enact laws authorizing banks to engage in new activities, which many have done already. By allowing the financial services industry to continue to restructure itself without imposing any guidelines or establishing any policies, Congress would lose the opportunity to channel reform into a comprehensive and sensible framework.

No one should be fooled that a moratorium on cross-industry activities or on state action is the answer. Despite the implications of its name, no moratorium would be temporary.

History is replete with examples of moratoria that have been extended year after year because Congress was unwilling to deal with the underlying issues. Moreover, unless in passing its moratorium Congress is willing to force divestitures, the horses that were first out of the gate may have a permanent inside track. Furthermore, a moratorium would have to stop all states from acting -- not just states like South Dakota which has authorized nonbanking activities for their banks outside the state, but states like New York, which has proposed such activities for banks in New York as well as elsewhere. Finally, a moratorium is unlikely to be effective even if enacted. The banking laws themselves have been unable to contain competitive forces. No moratorium is likely to keep change from occurring through the ingenuity of the market.

Thus, we think the time has come to put selfish interests aside and to unite behind a sound public policy. It is time for Congress to establish a legal framework for the financial services industry -- a framework that will forestall chaotic competition among the states, provide guidance to the regulators, and ensure that the interests of consumers are adequately served.

ADVANTAGES OF DEREGULATION

To the financial system. The enactment of legislation deregulating depository institution holding companies would strengthen our financial system by promoting safety and soundness and providing competitive equality. The holding company requirement would insulate depositories from undue risk and prevent unfair use of their cost of funds advantage. It would lessen regulatory disparities by requiring that nonbanking activities be conducted in a separate affiliate subject to the same treatment as other firms in the same industry. It would provide a structure by which banks and thrifts can remain competitive in the future.

To consumers. As a result of increased competition in a deregulated environment, consumers will benefit from a wider variety of services at lower prices and the convenience and efficiency of "one-stop" shopping. We see many examples already. As Chairman Shad of the SEC has testified, there now are more than 1000 banks and thrifts in the discount brokerage business. Many of these banks have combined money market mutual fund sweep arrangements with insured deposit accounts and discount brokerage services. Some have packaged these products in innovative central asset accounts that enhance customer convenience, savings, and information. Some banks are even experimenting with leasing and profit sharing arrangements that permit insurance and real estate agents to work out of bank lobbies and branches. Less regulated entities like Sears, Roebuck already have established on a nationwide scale "financial service centers" that combine the features of an insured depository with complete securities, real estate, and insurance services. These multi-service facilities make Sears perhaps the closest the industry has come to the much-heralded financial services supermarket. The "supermarket" experiment has been a tremendous success, proving that when presented with the option of one-stop financial services shopping, consumers will respond willingly and enthusiastically.

Often overlooked is the benefit to consumers of "bundled" services. By bundling, we are referring to the combination of services that permits lower distribution costs, not price tying of products. Much of the debate over new holding company powers focuses on the trade-off between the potential for unfair competition and the anticipated benefits to the public that would result from new financial products and services. A study by Chase, Brown and Blaxall, Inc. makes a strong case for the benefits of bundling that would result from new holding company powers.* Bank bundling of goods and services provides substantial economies of scale and scope, resulting in substantial savings to consumers in both time and money. Examples of the benefits of bundling include space sharing of costly brick and mortar branches with real estate, travel, insurance, or similar businesses; putting excess computer capacity to use; applying banking skills to other business; and avoiding duplicative "sales" costs. By enabling banks to bundle new products and services with existing ones, deregulation would lower the costs of banking and the costs of bundled services.

Another good example of consumer benefits from deregulation is Savings Bank Life Insurance. Research conducted by Consumer Reports shows this form of life insurance to be one of the best available. For policies with a face amount of $25,000, the Consumer Report rankings consistently list SBLI as one of the five least expensive policies available. The primary reason given for the low costs is that savings banks can offer the insurance on a walk-in basis. Clearly the consumer is the real winner in this competition.

Examples. The economic virtues of deregulation are well illustrated by our experiences with other industries. Deregulation forces a transition from a protected environment to the discipline of marketplace competition. Deregulation of the airline industry in 1978 and the trucking industry in 1980, for example, stimulated competition and provided consumers with a wider choice of services at lower prices.

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* Chase, Brown & Blaxall, Inc., The Role of Bundling in the Provision of Financial Services (February 1984), commissioned by the Association of Bank Holding Companies.

Even though some airlines have gone out of business since deregulation started, 14 new airlines have entered the business. While national carriers have reduced service to 74 smaller cities during deregulation, new commuter airlines have sprung up to provide service better suited to the needs of these markets, and, indeed, flight frequency in these markets is up 24 percent since deregulation. Airline productivity also has risen dramatically. In 1982 the airline industry provided 19 percent more output than in 1978 with only 1 percent more employees. While some short-distance airline fares have increased, long-distance airline fares declined almost 50 percent in constant dollars over the last seven years due to the elimination of cross-subsidization and the introduction of pricing tied to true costs.*

In the trucking industry, almost 10,000 new carriers have entered the business, more than taking up the slack of the 300 trucking companies that have gone out of business. The removal of ICC protection has produced a new emphasis on efficiency and marketing, and shippers can now choose from a much larger variety of rates and services. Sixty-five percent of manufacturers now get lower rates than before deregulation began. Despite the sharp rise in fuel costs, truckload rates are now 5 percent lower than they were in 1980, and in some cases are down as much as 30 percent.**

Deregulation of the securities industry also has produced significant benefits. Since fixed commissions were prohibited in 1975, discount brokers have proliferated, charging transaction fees that have been discounted as much as 70 percent from those of full service brokers. Furthermore, although some broker/dealers have consolidated or gone out of business, the number of broker/dealers registered with the SEC has increased steadily from about 5400 in 1976 to more than 9200 in 1983, a 70 percent increase.

Deregulation of the liabilities of depository institutions already has produced significant benefits by allowing banks and thrifts to pay consumers market rates on deposit accounts. For one thing, depository institutions, which just a short time ago were having difficulty attracting funds, currently are competing effectively for the savings dollars of the American public. And savers, many of whom were precluded from realizing the true value of their savings prior to deregulation, are now able to obtain a fair return on their capital. But the combined effect of a high market cost of funds and reduced earnings from business lost to less-regulated competitors is pressuring depository institutions' profit margins. The fee income they would earn from new products and services would clearly help them to reduce their dependence on currently limited sources of earnings while allowing them to better manage profitability in the face of market-driven costs. Thus, deregulation of depository institutions is yielding significant returns, and the time is right to further this process.

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* "Special Report on Deregulating America", Business Week, November 28, 1983, pp. 80-81 and 83-86.

** Ibid., pp. 80-81 and 86; "On the Rise: Iowa Trucker Prospers After Deregulation", Wall Street Journal, February 13, 1984, p. 1 et seq.

IMPORTANCE OF THE HOLDING COMPANY REQUIREMENT

I am particularly pleased that both S. 2181 and S. 2134 adopt the holding company approach the Administration has been advocating for several years and has embodied in FIDA. All three of these bills would require nonbank or nonthrift activities to be performed through a holding company or its nondepository affiliates, and not in the depository institution itself. As I have explained in prior testimony before this Committee, there are several reasons why the Administration believes strongly that the holding company structure is the only acceptable means of expanding nonbanking activities.

Banks and thrifts are unique financial intermediaries affected with a public interest. As such, they are Federally-supervised, have access to a Federal lender of last resort, and can offer deposits that are Federally insured. The Administration does not believe that these institutions should directly engage in new and risky activities that cannot be regulated effectively by bank regulatory agencies. This would place an inappropriate supervisory and insurance burden on the Federal Government. Moreover, the unique status of depository institutions enables them to raise money in the private financial markets at a lower cost than most other borrowers by allowing the payment of lower explicit returns and/or by enabling them to overcome more easily the caution of potential investors in placing their funds with the institutions. These institutions should not be able to use lower cost funds to subsidize their nonbanking activities. Nor does the Administration believe that nondepository institution activities should be conducted through a subsidiary or service corporation in which a bank or thrift has a direct equity investment. Such bank or thrift investments would be at risk if the subsidiary's activities were to falter, and the subsidiary's cost of capital would be lower as a result of Federal assistance not available to competitors. Neither problem arises if the holding company approach is adopted.

The holding company approach has the further advantage of permitting regulation by function, that is, of ensuring that firms engaged in the same activities are subject to the same rules, enforced by the same regulators. The adoption of this approach as the underlying principle of depository institution deregulation would remove many of the inconsistencies and anomalies that currently confuse the issue of bank deregulation.

COMMENT ON ESPECIALLY CONTROVERSIAL SECTIONS OF THE GARN BILL

Consumer bank exception. Senator Garn's bill would create an exception from bank holding company regulation for a limited-purpose depository whose commercial loans do not exceed five percent of assets and are restricted to small business lending and financing of consumer goods inventories.

We continue to be concerned about the competitive impact of this provision. Diversified financial service firms could add Federally-insured deposits -- the essence of banking services -- to their menu of new products, while traditional bank holding companies, offering the same banking product, would remain subject to the separation of banking and commerce and the requirement of Federal Reserve approval to conduct additional financial activities. Moreover, through ownership of a consumer bank, nonfinancial conglomerates would have access to Federally-insured credit to finance their sales of goods or services.

In January, I noted that the Administration has not yet taken a final position on the consumer bank issue. There is some real appeal to the concept of eliminating completely the regulation of holding companies for depository institutions, which could eventually be the effect of authorizing a consumer bank. We are interested in hearing additional discussion of the advantages of the consumer bank as well as further specification of its operational scope and restrictions. Nevertheless, we remain concerned about the problems discussed above.

On the related subject of including institutions that are eligible for Federal deposit insurance in the definition of "bank," some have expressed concern that FIDA's proposed definition, which would include uninsured industrial banks, is broader than is necessary to accommodate legitimate Federal interests. We are flexible on this issue, and I have instructed my staff to work with the staffs of the Federal Reserve Board and this Committee to see if a more acceptable definition can be developed.

Qualified thrift lender exceptions. Unitary thrift holding companies currently are exempted from activities restrictions if they meet a housing-related assets test. Activities of thrift service corporations also are potentially unrestricted. Instead of following FIDA's approach of eliminating these exemptions in order to provide equal treatment of the banking and thrift industries, the Garn bill endorses them as applied to a different class of thrifts.

To qualify under the Garn bill, a thrift must have at least 60 percent of its assets invested in residential mortgages or not more than 25 percent in commercial loans.

Like the consumer bank proposal, the qualified thrift lender exceptions would create substantial problems of competitive inequity. Under the "either/or" test, qualified thrift lenders would have five times the commercial lending authority of a consumer bank. No reason is advanced for this inequality, and it is hard to think of one. If there is to be a class of insured depository institutions whose holding companies are unregulated, vast differences in competitive value should not depend on whether a thrift or a bank charter is chosen. It is worth noting in this connection that the qualified thrift lender would also be able to take advantage of the liberal liquidity assistance, capital requirements, and branching authority available to the thrift industry, as well as exceptions from Glass-Steagall limitations. Moreover, by conducting nonthrift activities through service corporation subsidiaries, qualified thrift lenders would have a competitive advantage over banks and stock-thrifts that would still be subject to the holding company requirement and to restrictions on tying and interaffiliate transactions. The Administration is not opposed to providing for a "qualified thrift lender" exemption, but believes that thrifts should be considered qualified thrift lenders only on the basis that they be allowed to have only a small portion of their assets invested in loans other than residential real estate, and that this be the only exemption for a qualified thrift lender. In the interest of competitive equity, the exemption should be kept as narrow as possible and essentially be tied quite tightly to residential real estate lending.

In the hearings on S. 2181, the U.S. League of Savings Associations seemed to support a tight housing-related test, while the National Council of Savings Institutions argued that only the holding companies of commercial banks should be restricted. Neither suggested an appropriate test, but we believe that no persuasive argument has been advanced that S&L holding companies should be treated more favorably than holding companies of commercial banks, unless they contribute substantially to investment in residential housing.

In addition, we believe that traditional savings banks, because of their historical reliance on liability rather than asset powers, are sufficiently unique to justify an interim "test." We recommend that in order for these thrifts to be qualified thrift lenders, they should be required to have the same portion of their loans in residential real estate as S&Ls, but should be given a generous time period to reach that required level.

We have serious reservations about the broad service corporation exemption because it permits some financial service firms to diversify within the depository institution rather than through the holding company, thereby creating competitive inequities between such firms and firms subject to holding company regulation. We believe that the limitations on service corporation activities of qualified thrift lenders should embody the same principles as FIDA, with appropriate distinctions between stock thrifts and mutual thrifts.

The National Council of Savings Institutions has proposed a procedure to permit mutual thrifts to use to form holding companies. We would be glad to pursue this proposal further with the NCSI and the Committee. To the extent that laws may be adopted to facilitate holding company formation by mutual thrifts, there may be no reason to treat the powers of mutual thrift service corporations differently from those of stock thrifts.

Limitations on financial industry concentration. Senator Garn's bill restricts combinations, through holding companies, between large depository institutions and large firms engaged in nonbanking financial services activities. These restrictions would cover approximately the 25 largest bank holding companies.

These restrictions have been proposed in response to some expressed concerns about the potential for what has been called "undue concentration of resources." Many believe that the current antitrust laws are inadequate to prevent such concentrations.

The Administration is not convinced that size is inherently bad or that current antitrust laws are inadequate to deal with these concerns. Accordingly, we do not believe that any restrictions on institutions' size other than those under existing antitrust provisions are necessary.

Anti-tying provisions. Opponents of increased holding company powers, particularly the insurance and real estate industries, argue that banks' power to provide credit gives them a unique opportunity to force customers to accept other services. The power to tie products, they say, will result in unfair competition and drive real estate and insurance agents out of business. We are certainly open to further anti-tying suggestions although we would note several points: the impact of the Garn bill's proposed restrictions on tying, the limited role of banks in today's credit markets, the lack of an economic incentive for lenders to engage in tying, and the benefits to consumers of permitting new activities subject to regulation as an alternative to an absolute prohibition.

First, we believe the insurance and real estate industries fail to take sufficient account of current and proposed restrictions to prevent tying abuses. In addition to traditional antitrust protections under the Sherman Act, which requires proof of market power in the tying product, the Bank Holding Company Act and the Home Owners' Loan Act already contain stronger measures prohibiting banks and thrifts from tying their services to other services offered by the depository or its holding company affiliates without the need to establish the existence of market power. Injured parties and those threatened with loss or damage may sue for treble damages and injunctive relief.

To lessen concerns that litigation costs may prevent some private lawsuits, FIDA would strengthen enforcement of existing anti-tying provisions by permitting trade associations to bring actions for injunctive relief on behalf of any of their members.

The Garn bill includes FIDA's amendment and also adds specific restrictions, suggested by representatives of the insurance industry, on how insurance may be sold. For example, a bank would have to disclose to a credit customer that credit insurance can be purchased from an independent insurer, and would have to accept cancellation of a credit insurance contract if notified by the borrower within 30 days. Recognizing the concerns of the insurance and other industries about tying, the Administation supports the Garn bill's stronger anti-tying provisions for all depository institutions, including thrifts (which would be covered by FIDA's restrictions but not the new Garn bill restrictions) and consumer banks (which would not be covered by any of the Bank Holding Company Act's anti-tying restrictions), provided these provisions do not amount to unnecessary reregulation. We would be willing to work with the Committee to develop appropriate standards for all nonbanking activities.

Second, those who assert that banks' power to allocate credit is sufficient to justify barring them from new financial service activities ignore the realities of today's credit markets. The study by Chase, Brown and Blaxall, Inc. indicates that:

> "The market for credit is highly competitive, and banks provide only about one-fourth of total credit in the economy. It is only in short-term lending to corporations that they account for more than half the total market."

The study points out that at the end of 1982, commercial banks held only about 26 percent of the more than $5.6 trillion of credit market debt, and thrifts and credit unions accounted for only 15 percent. Moreover, banks' and thrifts' combined share of total credit fell significantly during the last decade. Citing, among other things, the Federal Reserve Board's 1979 study of insurance tie-ins by bank holding companies, the Chase, Brown study concluded that "banks do not have the market power that would be required to coercively tie other products to their extensions of credit if customers did not want the bundled packages."

Third, even if banks had the market power to require borrowers to buy other products from them, a more profitable way to use that power would be simply to charge higher interest rates on loans.

Finally, those who rely on the tie-in argument as a reason to prohibit new powers fail adequately to balance the possibility of abuse against the combined benefits of competitive equity and consumer welfare. An absolute prohibition against offering new financial services simply cannot be justified when there are overriding benefits to be gained and the risks of abuse can be managed adequately by regulation.

CRITIQUE OF TRADE ASSOCIATION COMMENTS ON GARN BILL

Protecting special interests. The Committee has now heard from all of the trade groups that would be most affected by the proposals -- the banking, thrift, securities, insurance, real estate, and nonbank financial service industries. The states, small businesses, and consumer groups also have expressed their views. Confirming everyone's expectations, opponents of the proposals in S. 2181 once again proclaimed their allegiance to competition and free enterprise but cited reasons why in this case it just would not work.

The securities industry, for example, is outraged by regulatory restrictions on brokered deposits -- citing the benefits consumers receive from this new service. In reality, however, brokered deposits are significant because they give the securities industry -- which has always had access to consumers' investment funds -- access for the first time to consumers' savings. The industry gladly reaches for this benefit, but at any suggestion that bank holding companies might be able to compete with them for the investment funds of consumers, the securities industry cries "Foul!".

The insurance industry questions whether the holding company requirement adequately insulates depositories and whether the proposed anti-tying provisions -- or indeed any tying restrictions -- can protect it from unfair competition. But insurance holding companies, whose subsidiary insurance companies, much like banks, hold the savings dollars of millions of consumers, are virtually free of regulation, without apparent danger to the solidity of insurance companies, and at least two major insurance companies - Allstate and Prudential - are already affiliated with depository institutions through holding companies, without any allegations of tying. Moreover, as I have said, we do not believe that tying will be as serious a problem as opponents of deregulation have argued.

The real estate industry also cites tying concerns in opposing banks' new real estate brokerage and development powers. But with the advent of a national mortgage market -- in which homebuyers have access to mortgage lending outside their localities through computerized networks -- S&Ls and banks are beginning to claim that realtors are freezing them out of mortgage lending because of tie-ins with mortgage brokers and other participants in the national mortgage market.

In my view, each of these opponents of deregulation is trying to protect its own competitive turf. Perhaps we should expect no more than this, but that does not mean that we should be swayed by their arguments, especially when the curious outcome is always the same -- each of these industries faces less competition and the consumer pays more for his financial services.

I should note, however, that the Securities Industry Association, the Investment Company Institute, and the Alliance of American Insurers, while opposing FIDA and the Garn bill, have presented their positions on how new powers for depository institutions should be granted, if they are to be granted. We commend these efforts and urge other groups to do the same.

Inconsistency of opponents' arguments. I would like to address a few specific points that illustrate the inconsistency of the arguments made to this Committee during the hearings on S. 2181. In my view, the charitable way to describe these arguments is disingenuous. For example, insurance agents and underwriters argue that the combination of lending and insurance agency powers creates the danger of anti-competitive tie-ins. If this is so, why is it not also a problem when insurance companies act as lenders? An insurance company could, for example, as a condition of a loan, require that its securities or investment management affiliate take over the management of the borrower's pension plan, or that the borrower buy insurance solely from the insurance company. Does anyone doubt the reaction from the insurance industry if, for these reasons, affiliations between insurance companies and investment managers were prohibited, or insurance companies were prohibited from engaging in corporate or consumer lending?

Similarly, the securities industry has argued that banks should not be permitted to engage in securities underwriting because of the dangers that banks would engage in "stuffing" of securities into trust accounts or bank investment portfolios. If there is danger in "stuffing," however, it applies to securities underwriting firms that also have discretionary accounts, or manage mutual funds, or are affiliated with insurance companies. Of course, there are laws that prohibit stuffing of customers' accounts and prohibit investment companies from buying securities from affiliated underwriters. And there are insurance regulators who review the investments of insurance companies. But that is just the point: the problem is handled by regulating the abusive transaction, not by prohibiting the affiliation. Can anyone imagine the outcry from the securities industry, however, if it were suggested that affiliations be prohibited between securities underwriters and investment managers or large institutional investors?

In this regard, the SEC has suggested several additional measures to improve the legislation, including one to prevent conflict of interest abuses by requiring the consent of trust beneficiaries in advance of any bank purchases as fiduciary of securities or assets from affiliates. We suggest the Committee give serious consideration to these suggestions.

The securities industry also argues that banks' power as lenders will enable them to force issuers of securities to use the banks' affiliates as underwriters. Again, if lenders can and do force borrowers to use securities underwriters affiliated with the lender, the same abuse can occur when insurance companies are affiliated, as many are, with securities underwriters. No one is suggesting, of course, that these affiliations be terminated.

More generally, critics of bank deregulation often speak of the dangers of conflicts of interest if a bank were to be affiliated with a nonbanking firm. It is argued that banks would withhold credit from competitors of their affiliates. If these conflicts really exist, the same problems arise when insurance companies engage in commercial lending, while at the same time maintaining affiliations, through holding companies, with nonfinancial firms. But even apart from this, there is much evidence in today's marketplace that this is a fantasy. Banks have long competed with securities firms in underwriting municipal general obligation bonds; at the same time, the very same banks have been making broker loans to their competitors, allowing them to carry a competitive inventory of securities. This seems to work comfortably without abuse. If someone were proposing today to allow banks, for the first time, to enter the business of underwriting and dealing in municipal general obligation bonds, can there be any doubt that the securities industry would be claiming that their sources of funds would be cut off by such a step? Can there be any doubt about what is the real motive for such a claim?

Instead of creating loopholes to expand their own activities and devising arguments to keep banks and thrifts out of their business, we think the insurance and real estate industries could put their creative efforts to better use by making deregulation work for them. Product deregulation will not only benefit banks and consumers, it will enhance the ability of other financial service firms to meet their customers' needs by permitting them to diversify into banking. Discount brokerage arrangements with banks already have shown us how the combined strengths of the securities and banking industries can work to everyone's advantage. Independent insurance agents, facing heavy competition from direct writers of insurance, are improving their marketing strength through space-sharing arrangements with banks. Deregulation would further enhance their ability to take advantage of banks' marketing capabilities through profit-sharing arrangements. Realtors similarly could benefit from deregulation by, for example, working with regional banks to improve their name recognition and provide customers with greater mortgage underwriting capability. Thus, we think opponents of deregulation would do well to consider the potential opportunities that will arise from enhanced relationships with depositories.

CONCLUSION

The Garn bill represents good public policy. All of the depository institution regulators as well as the Administration have reached a consensus that enactment of the Garn bill is in the best interest of consumers and the financial system. The bill would resolve many of the anomalies and inconsistencies in the current scheme of regulation. It would give depository institution holding companies new powers to promote competitive equity and provide consumers with the benefits of enhanced competition. And, the bill would create a framework for equal competition in the future.

Responsible public policy demands that Congress act now on this much needed legislation, or otherwise allow state legislators and creative lawyers to set financial policy for you.

In closing, you have three choices.

First, you can continue to do nothing, and allow the marketplace, the states, and the Federal regulators to mold the financial services industry as they see fit.

Second, you can require financial, non-financial companies, and the states to turn back the hands of time and undo actions that have already been enacted.

Or third, you can enact legislation which will respond to the realities of today's marketplace and put in place a structure which will preserve the safety and soundness of our nation's depository institutions while creating an environment for necessary and equitable competition.

Mr. Chairman, I believe that you and I are in agreement that the latter is the only acceptable alternative. I therefore urge you to move directly into the mark-up phase of this process. The marketplace, the regulators, and the states are watching and waiting for a sign from you and your Committee. The strongest message you could send is to proceed without delay with the mark-up of S. 2181.

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Mr. Chairman, that concludes my testimony. I will be pleased to answer any questions the Committee may have.

The CHAIRMAN. Thank you, Mr. Secretary, and we will include your entire detailed statement in the record.

I might first ask you if you would respond to Senator Tower's comments about the TIM's proposal.

RESPONSE TO TIM'S

Secretary REGAN. Certainly, Mr. Chairman. You will recall, Mr. Chairman, the TIM's legislation is very complicated and as a result we at the Cabinet Council on Economic Affairs [CCEA] went over it very carefully.

We came up with some proposed laws which I believe have been shown to both of your staffs and also to the staff of the Senate Finance Committee.

We got quite a bit of opposition to our proposal because the industry is in the process of changing. What we saw in 1983, certainly by now in 1984, has changed considerably. As you know, the housing industry now is at an annual rate of 2.2 million starts. The industry itself has worked out with CMO's and other things what they think is a satisfactory solution. And we noticed, for example, just the other day that the U.S. League has withdrawn its support of TIM's which it had ardently supported back in 1983, saying they don't need it at this moment.

So what we have done is to take back our legislation, rethink it, and we will be submitting it to you, even though we recognize that there will be an awful lot of opposition to this bill at this particular moment because most of the industry thinks that the status quo—that is, the arrangements that they themselves have made—are sufficient for the time being.

My own prediction would be that if housing starts turn down and get back to an annual rate of 1.7 million there would be a loud outcry for the TIM's legislation. So I think it's something that we should submit to you and have you hold hearings on, and then see whether or not you want to proceed with it.

The CHAIRMAN. Well, I would agree with you. The next time there's a downturn they will be back saying, "Why didn't you do something about this?" Unfortunately, it happens over and over. We discussed this yesterday, how Garn-St Germain probably would not have been enacted without the crisis in the thrift industry, and I would agree with that. That was a great motivating factor.

What I have been trying to do is move the committee and the Congress along without having to wait for another crisis to enact this legislation. That's why I feel strongly about TIM's. The need right now—they may be correct—may not be there. Not just Congress but industry as well—how shortsighted are we that we never seem to learn the ups and downs? And we have been through many housing cycles just in the relatively few years that I have been here. I would think it would be time for some foresight and have something in place for once prior to the problem occurring.

So I hope you will move ahead and we will try and be a little more foresighted than some of those who will wait and then say, "Why didn't you do this?"

Senator TOWER. Would you yield to me, Mr. Chairman?

The CHAIRMAN. I would be happy to yield.

Senator Tower. I just wanted to endorse what Chairman Garn has said. I don't see why we should hesitate to hedge against another potential downturn and go ahead and do everything that we can to stimulate private participation and encourage private participation in the secondary mortgage market. And we note that without this legislation there seems to be in the private sector some transactions such as the Sears transactions, and I wonder if there will be more of those.

Secretary Regan. Well, as you know, that has been under sort of a cloud and people are worried about what the effect will be and how far they could go. Frankly, I think the legislation would settle it, but again, I just want to point out that when we send it up it is going to be very controversial because there will be strong opinions on both sides regarding the advisability of having such legislation at this time. But, nevertheless, we will send it up.

The Chairman. How much of a problem are you having with it over the issue of Freddie Mac and Fannie Mae getting involved?

Secretary Regan. Quite a bit. The Mortgage Bankers Association told me yesterday—I made a speech to their group—that they would back the legislation if Freddie, Fannie, and Ginnie were all part of the legislation, but without them, they would not support it.

On the other hand, the very purpose of TIM's is to try to get the Government out of that market. So again, you're going to have controversy the minute you say that the Government should start phasing its way out of that market. Others are going to say absolutely not.

The Chairman. Well, I want to make that point and that's why I asked the question. My intent is not to hurt Freddie, Fannie, and Ginnie at all, but they do have the majority of the market now. They have gone up to $114,000 and I have no intention of trying to undermine that market at all. But if we are going to develop a private secondary market to encourage above that, I think it makes a great deal of sense and certainly there's still plenty of room for those quasigovernmental agencies to work in that vast majority of where the mortgages are.

I want to make that very clear. The intent of this legislation is to develop a secondary market. The secondary market becomes more and more important as we see all of the attempts to find alternative mortgage means and, again, we get back to the next crisis and thrifts are not going to want to hold mortgages. That's why they got into the difficulty to begin with. And then they will be saying, "Where can we get rid of these mortgages? Where can we turn them over?" So the privatization issue over and above that amount and the development of the secondary private market I think is still highly important.

Secretary Regan. Well, my understanding is, Mr. Chairman, that the U.S. League, for example, would not support the legislation if Freddie and Fannie were included. So there we have the essence of the argument. Frankly, I don't think they should be. I think they should be on the outside and held in reserve while we develop a private market.

The Chairman. Well, this place is no fun if there's no controversy anyway. If the room weren't filled and there weren't all kinds of problems to solve it would sure be dull.

Secretary REGAN. I'll sure say it's not dull now.

Senator TOWER. I'd welcome the dullness.

The CHAIRMAN. Well, unfortunately, for the rest of us, you will probably have some dullness next January while we are still struggling and you are out enjoying. He's going to privatize himself next January. [Laughter.]

Mr. Secretary, there's been a great deal of talk the last few weeks about brokered deposits. As you know, the FDIC, the FSLIC, and the Bank Board adopted a final rule on Monday which is a modification of their proposed rule during the comment period and effective until October and then phased in over a 2-year period for current brokered deposits.

What is your view of the final rule that they have recommended and do you feel that it's taken care of the problem?

Secretary REGAN. Well, Mr. Chairman, I have to be careful of my answer here. I took myself out of consideration of this issue when it came before Treasury and when it came before the Cabinet Council on Economic Affairs because my old firm, as you know, is the leader in one very definite opinion on this.

INSURING AGENCIES MAY HAVE GONE TOO FAR ON RULING

But overall, speaking for Treasury, we think that perhaps the insurance agencies have gone a little too far in this recent ruling. We would not have gone that far. As a matter of fact, the Comptroller of the Currency voted against the action of the FDIC.

Yes, there is a problem here with brokered funds and it particularly applies to failing institutions or institutions that are trying to get ahead too fast and stumble on the way.

The real problem, as I see it, is in what is done with the funds, not with the funds themselves. The loans and the types of loans that the institutions themselves have made, that's what got them into trouble, not the fact that they had received brokered funds.

We think that the prohibition should be against the use of brokered funds by institutions that are on the verge of or are getting into trouble and we have noticed that such a rule has been put into effect now.

Accordingly, we don't see why people who live in one section of the country shouldn't be able to use the services of someone in another section of the country in order to get higher rates of interest. That's all that we could see that these brokers were doing.

The fact that both of the insurance agencies have decided to protect themselves by going this far we think is a mistake and we think that the Congress probably should look into this matter and enact some legislation to straighten it out—again, on behalf of consumers. I don't think that the consumers' interests have been looked at here. I think it's just been the insurance agencies trying to protect their own turf, their own funds, rather than looking at what is the overall good for American taxpayers and American citizens.

The CHAIRMAN. So you feel that even the modified rule as adopted goes too far?

Secretary REGAN. I do.

The CHAIRMAN. Yesterday, Chairman Volcker testified that he supported their action, in effect saying it was the only ball game in town right now, but that he felt that we should have a legislative solution.

I interpret from your last remarks that you would agree with that, that rather than leaving it up to the regulators, that we should hold hearings and make our own decision on brokered deposits.

Secretary REGAN. I would recommend that course of action to you, Mr. Chairman, and in fact would agree to work with your committee through Treasury to bring out any facts you might want.

The CHAIRMAN. Senator Tower.

Senator TOWER. Mr. Secretary, I'd like to ask just one question related to TIM's.

Do you believe that the CMO is a better tool for the securitization of mortgages than the TIM's?

Secretary REGAN. I think that I'd personally rather see legislation in this area that would definitely state what could or could not be done.

As you know, while the CMO has some legal backing, its role has never been literally defined and it's going to take a long process of court action to determine what the powers of a CMO really are.

I would rather see that spelled out by the Congress rather than leave it up to the courts to make this decision. That's why I would favor TIM's action rather than just having CMO's, but with the understanding that what has been done by CMO's up to this point would be grandfathered by any subsequent legislation.

Senator TOWER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Mr. Secretary, I was interested to read of your recent activities in Japan on issues of trade and finance. I was most interested in the Japanese demand that we change our laws to allow interstate banking. What are your feelings about this demand?

EQUAL FINANCIAL TREATMENT

Secretary REGAN. Well, what I would like to see is national treatment, Senator. I don't think that our financial institutions get equal treatment in Japanese markets to what Japanese financial institutions get over here, and I have made this point, I hope, loudly and clearly to the Japanese on my recent visit there.

What I told them was this. At this moment, a Japanese bank can come in and buy a U.S. bank and set up operations. One of them in fact did buy the Bank of California. By grandfathering, the Bank of California had the right to do banking in three States—California, Oregon, and the State of Washington. As a result, now a Japanese bank can do business in those three States. That's not permitted under our laws for Citicorp, or Chase, or any other bank in the country.

I don't see why we allow that type of thing because certainly if one of our banks had openly tried to do what their banks are doing, for example, trust business, they would not be allowed to do trust business in Japan. Yet the Japanese bank can do trust business in the United States.

Similarly, our brokerage firms cannot join the Tokyo Stock Exchange. Yet Nomura, Niko, and other Japanese brokers are members of the New York Stock Exchange.

Why not have equal treatment? Why not open up their markets?

They seem to want to play a one-way street here and that's to put banking on the board to open up their markets. It's for that reason, among other things, that the yen-dollar relationship is not a correct one. They protect that yen. As a result, it's much weaker than it should be.

It should be a strong currency. If Japan is No. 2 in trading, why isn't the yen the No. 2 currency sought after in the world? It's not. The pound sterling, the deutsche mark, the Swiss and French franc, all these currencies that are more in demand than the yen. Why? The Japanese will not allow that yen to float free.

To give another example, how are their imports paid for? In yen? No. Wouldn't you think they would pay for them in their own currency? No. Only 3 percent of Japanese imports are paid for in yen, 97 percent are paid for in dollars. So what's happening? There's a demand for dollars, but no demand for yen.

If there were a difference, that yen would be much stronger than it is today and, as a result, our exporters would be on a much more even footing with Japanese exporters in competition around the world.

Senator HECHT. Let's get back to banking because this is the Banking Committee. Do you think we should enact any type of legislation on the grounds you have just spoken about?

Secretary REGAN. Senator, I would suggest that we hold that question in reserve until we see what happens. The Japanese have promised us that they will do something. They have promised that sometime in April they will have some new regulations ready toward opening up their markets and internationalizing the yen. Let's see what happens. If they don't, we always can fall back on that. I would rather not get into this punitive type of action unless it's necessary. If indeed the Japanese open up voluntarily, then I think they should be allowed that opportunity; but I admit that time is now short.

Senator HECHT. But if they don't, you think it might be necessary for us to act?

Secretary REGAN. I think it might be necessary, yes.

Senator HECHT. Thank you. One other international issue before we get on the banking act. There's been much news lately about Argentina and meeting their repayment demand of $43 billion loan. Are they going to be able to work this out?

Secretary REGAN. I don't know, Senator. I know that there's a lot of talk. We're trying to get some action. The Argentines sent a new representative to talk to the International Monetary Fund last week. They are trying to see how far they can go politically to satisfy the economic and financial demands of the International Monetary Fund. If they are able to satisfy the International Monetary Fund and sign a Letter of Intent that they intend to abide by the rules that the IMF has set for borrowings from the Fund, then both the banks and the IMF will lend Argentina the money it needs to continue its international trade, to continue to service its debt.

If they don't agree to an IMF program, I don't think they will get the money. If they don't get the money, obviously they are not going to be able to pay the interest on their debt. That means that our banks, French, German, British, and Japanese banks will all take a hit to their earnings for the fact that Argentina is not making payments on its debt.

Senator **HECHT**. Do you see any problem with the capital of our major banks that have lent to Argentina?

Secretary **REGAN**. No, I do not. First of all, not all banks will be hit. Second, the hit will not be distributed equally among the banks. Even for the ones that do have to take a hit, their capital is not in jeopardy. Their earnings may be off, but their capital will not be in jeopardy.

Senator **HECHT**. The stockholders then will take another look. Will this have any effect on our own interest rates in America?

Secretary **REGAN**. I don't believe it should. I think that's an entirely separate discussion, although I admit that if banks' earnings are tailing off there's not going to be a desire on the part of banks to shrink the margin of profit that they are getting now from some of their loans. Accordingly, it will make it a little more difficult to get our interest rates down, but there will be no real cause and effect of high interest rates.

Senator **HECHT**. Should the problems in international lending have any bearing on what we are doing today?

Secretary **REGAN**. No, I don't think so. I think what we are trying to do today, Senator, is to give banks another marketing tool allowing them to go into other areas of financial services. I don't think that has anything to do with whether or not a bank or any group of banks are making loans to foreign countries.

INTEREST RATES ON RISE AGAIN

Senator **HECHT**. You have minimized the effect of high deficits. With our current economy expanding, why are interest rates on the rise?

Secretary **REGAN**. If I might correct your statement, Senator, I have never minimized high deficits. I have always believed that high deficits should be brought down.

What I tried to say in 1982, although it was misinterpreted, I again said in 1983 and I'll say again in 1984: we could finance our deficits in 1983 and 1984 without crowding out private borrowers from the marketplace. I didn't say that the high deficits were good or that they didn't matter. I said that we could finance ourselves even though we had those high deficits.

But we cannot continue indefinitely with these high deficits because sooner or later we will crowd out the private sector, and that's why we're so concerned and why we want to get deficits down.

Now there are a lot of people who are afraid that we in the administration will lean on the Fed to accommodate these huge deficits, monetize them if you will. We have not said that to the Fed. We are not going to say that to the Fed. But there is that fear, and the fear that the Fed will monetize the debt and thereby produce inflation is keeping interest rates up.

Yes, there is an indirect linkage between high deficits and high interest rates, but it's only because of this fear of further inflation.

Senator HECHT. Do you think this package of a $150 billion downpayment will help alleviate the situation?

Secretary REGAN. I very definitely do, Senator. I think it's the most that we can expect the Congress to pass this year. I don't see, in spite of the rhetoric that I have been hearing and reading about in recent days, that much more could be done in this area. But if it is done and the marketplace realizes that the Congress and the administration are both sincere about trying to get that path of deficits going down, they will take heart that we will eventually win this fight, and I think you will see interest rates coming down.

Senator HECHT. Let's get back on brokered deposits. We were told during these hearings that some of the banks had in excess of 40 to 50 percent of their footings in brokered deposits. Do you think the regulators were doing their jobs properly by allowing the banks to have so much brokered deposits? Some of the banks have failed.

PAYING CLOSE ATTENTION TO BROKERED DEPOSITS

Secretary REGAN. Well, I think that where the cutoff point comes is whether or not the regulators are watching what these banks or thrifts are doing with the brokered deposits. It's not the deposits themselves; it's what banks are doing with them. How are they handling that money once they get it in the front door? How is it going out the back door? If it's going out in the form of good loans, if it's going out in the form of proper banking practices, I see nothing wrong in that. But if it's going out in a slipshod fashion just to make a marginal profit in order to try to save a failing institution or something of that nature, yes, I think that's wrong and I think the regulators should be cracking down on that.

Senator HECHT. Well, when banks increase their deposits they have to increase their capital. When so much deposits are brought in without an increase in capital I fail to understand how the regulators were doing their job if they were not watching this.

Secretary REGAN. Well, I haven't looked into that specifically because, as I said, I tried to take myself out of consideration of these factors because of possible conflict with my old firm, so I'm not really an authority on that. But for the record, if you wish, I will have somebody in Treasury prepare an answer to that question.

[The following information was subsequently filed for the record.]

Answer to Senator Hecht's Question About Brokered Deposits

Question

Were the regulators doing their job when they allowed banks to increase their deposits through brokered deposits without simultaneously requiring an increase in capital?

Answer

The growth of brokered deposits is a relatively recent phenomenon with which regulators have had to deal. Access to these deposits has enabled institutions to increase their deposit base very rapidly. However, due to the examination cycle for banks and thrifts, regulators did not become immediately apprised of the problems arising from institutions that used brokered deposits to grow rapidly. As the magnitude of the problems has become much more apparent, however, the regulators have taken several definitive steps to address the regulatory concerns associated with the use of brokered deposits.

Some of these major steps are as follows: (1) All Federally insured institutions, as of September 30, 1983, are required to report their volume of brokered funds on a quarterly basis. This step was taken to enable the regulatory agencies to monitor the amount and distribution of brokered funds. (2) Both the Federal Deposit Insurance Corporation (FDIC) and the Federal Home Loan Bank Board (FHLBB) have stipulated that all problem institutions wishing to utilize brokered funds in excess of five percent of their deposit base must provide written notice of their intent and adhere to more detailed reporting requirements. Regulators have been authorized to reject, if deemed warranted, an institution's plans to acquire additional brokered funds. (3) The agencies adopted a final rule on March 26 that limits insurance coverage to $100,000 per deposit broker per institution. This rule was prompted by numerous considerations, but one of the practical effects of the rule is to prevent an institution from growing so rapidly that its safety and soundness is jeopardized. As an interim measure before the rule becomes effective on October 1, the FHLBB has also ruled that no institution whose net worth is less than three percent of liabilities may accept more than five percent of its deposits through a deposit broker. (4) The FHLBB has now proposed a rule that would impose on thrifts a net worth requirement equal to at least three percent on any increase in liabilities after December 31, 1983.

In summary, then, the regulatory agencies have faced some serious challenges in monitoring the use of brokered deposits by depository institutions. While the Administration does not agree with the final rule restricting insurance coverage on brokered deposits, we do recognize that the FDIC and the FHLBB have responded to the regulatory concerns arising from the use of brokered funds.

Senator HECHT. Thank you. Let's get back on the bill. It has been suggested that in order for Congress to act on any legislation of this type that a crisis must occur. In your opinion, do we have a crisis now?

Secretary REGAN. I think we have had a crisis for the past 3, or 4, or 5 years. Things are getting so mixed up now that it's very difficult to tell who the players are and what game they are playing. And unless the Congress sorts things out pretty quickly, the market will be irretrievable, in my judgment, because it's only natural that artful lawyers, accountants, and financial people are going to seek loopholes to come up with new types of endeavors that cross over various lines. I know, I caused a lot of this problem myself personally by what I did. I'm trying to be part of the solution now, but I think that unless we—and by we I mean the admintistration and this Congress—put aside all the pleas we are hearing from the selfish interests—and believe me, had I my old job, I would probably be at this table arguing the other side of the case, so I think I know perhaps better than anybody in the United States both sides of the argument—I'm telling you that the Congress has to act and act now or it will never be straightened out. If you let this go another year or 2, I hate to think of how you would ever straighten it out.

Senator HECHT. Must we take this comprehensive route or can we simply close the loopholes and restructure the environment that has served this Nation so well this past 50 years?

Secretary REGAN. Don't try the Band-Aid solution. You need to take a look at the overall situation and have one comprehensive bill. Have the courage that your predecessors had when they enacted the bill 50 years ago, whether it was Glass-Steagall or any other banking act. They didn't try for a Band-Aid solution in those days. I don't think you should try for a partial solution today. I think you should take the plunge and go the whole route.

Granted, it's going to step on a lot of toes, but on the other hand, what the heck is American capitalism all about if it isn't competition? Why do American capitalists—bankers, insurance companies, securities brokers and the like, all of whom are self-proclaimed capitalists—want protection and want a cartel? What they're telling you is that they won't face up to competition—protect me, I need protection against somebody else. My profits need protection, my job needs protection, my salary, my bonus, needs protection. That's what they're telling you. Don't believe them. Make them compete. That's what they get paid to do. But set the rules so that they can compete on even ground.

Senator HECHT. But banks are different from other businesses.

Secretary REGAN. No, they are not, Senator.

Senator HECHT. Just a second, Mr. Secretary. We have FDIC guarantees on deposits where other businesses do not. If a clothing store goes bankrupt, nobody is hurt; but if a bank in a small town goes bankrupt, many people are hurt and the taxpayers of America have to take care of this.

BANKS ARE SAME AS OTHERS IN THE INDUSTRY

Secretary REGAN. No, the taxpayers don't. The FDIC funds and the FSLIC funds are sufficient to protect the small depositors. What happens if an insurance company goes broke? What about the policyholders? What happens if a securities brokerage firm goes broke? They have a fund which is semiprivate.

I don't think that banks should be protected in the sense that nobody should compete with them. On the other hand, I don't think that other financial industries should be protected against banks. In addition, the Garn bill contains a holding company requirement to insulate the bank itself from the other activities that they will be allowed to engage in.

Now if you want a classic example, in the very industry that's protesting this bill, the securities industry, practically every brokerage firm owns mutual funds that they operate through their holding company. The Investment Company Act of 1940 says you cannot use your mutual fund to bail out the holding company or any subsidiary of it, and the SEC has carefully enforced that prohibition. And in the days when brokers were failing left and right—and believe me, I was in the middle of that—1968, 1969, and 1970—not one of them that had a mutual fund was allowed to touch that mutual fund nor was the mutual fund allowed to bail out the parent.

That's exactly the kind of protection the Garn bill provides for the bank. The bank is insulated. It's protected against the failure of a real estate subsidiary, or a brokerage subsidiary, or any other subsidiary, or indeed the holding company itself.

Senator HECHT. But it's been stated that out of the 14,500 commercial banks, relatively few would be large enough to have a holding company. Would this give an unfair advantage to the larger banks?

Secretary REGAN. No. The Garn bill streamlines the procedures under the Bank Holding Company Act and the Securities Act to form holding companies. This will make it easier and less costly for banks to reorganize as holding companies in order to take advantage of the new powers.

Senator HECHT. Let's get back to the smaller banks. Why do you have such confidence they can get into the different new programs?

Secretary REGAN. Well, to take an example, if the small bank enters the insurance brokerage business, I don't think that that will cause the bank to fail. It might upset the small town insurance broker who might be a customer of the bank. Maybe the bank for that reason wouldn't want to get in. But having made the decision to get in, I don't think that this would jeopardize the status of the bank as a viable institution. The same is true if they want to become a real estate broker.

Senator HECHT. How about real estate development?

Secretary REGAN. There's a provision in the Garn bill limiting real estate investment and development to 5 percent of capital, I think that's enough protection for the small institutions.

Senator HECHT. I think my time is up.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

Senator Riegle. Mr. Secretary, I understand that before I came in you made a comment in response to one of my colleagues to the effect that banks are not different from other institutions. Am I hearing that correctly?

Secretary Regan. Well, what I was referring to is that as far as competition is concerned and protecting banks from competition from others, others should be allowed to compete with banks just as banks should be allowed to compete with other financial service firms.

Senator Riegle. Let me ask you this. As we watch this commingling of financial functions with banks getting into certain nonbanking activities and nonbanking institutions getting into banking-type activities, what would you say is the definition that we should use today for a bank? I mean, as we think of banking, how would you define that today? What is unique and special about it?

Secretary Regan. I think in general that the definition used in the Garn bill is a good one—that a bank is an institution that has insured deposits, is eligible for deposit insurance, or makes commercial loans and accepts demand deposits.

Senator Riegle. I asked this question yesterday to Chairman Volcker and I'm going to just read you his response because I would be interested in knowing if you agree with it or if you have differences in emphasis because this is a very fundamental question that lies at the heart of where we go next here.

I asked him a question similar to the one I just did to you as to what is so unique about a bank and why would they have to be preserved in certain ways in terms of the way we would handle this legislatively.

This was his response—I'll just quote him directly. There may be a misprint in here because this is the rough typed committee print at this point and it hasn't been corrected:

> Mr. Volcker. Well, banks are essentially custodians of the payments system and the money supply and that's a pretty important function in any economy and in our economy. They are also the primary and they're going to remain the primary suppliers of particularly short-term credit for businesses and others throughout the country, and I think there is a continuing interest that they exercise that function impartially which gets into the conflict of interest area. They are the custodians for the savers of this country. They are the dominant financial institutions, but their uniqueness related to their involvement in money and in the payments system and in narrowing my scale a little bit, their provision of short-term credit throughout the country. This has always, for many many years anyway, been reflected and recognized in public policy by the protections that we provide uniquely to banks. Why was the Federal Reserve created? Precisely for this reason. Why was the FDIC created? Precisely for this reason. We have an interest in those institutions being sound and stable and providing a continuous effective service. We haven't got—it has not been judged throughout the years—we've got interest in other industries, but not to the same degree, not to the same amount of sensitivity. We don't have other apparatus for protecting other industries as a matter of course. It has also involved on the other side certain responsibilities by those institutions which are reflected in various public policies. That is, I think, the essential uniqueness of banks. It is a matter of fact. It is a matter of public policy.

Would you subscribe to that word for word?

CREATED FOR CONSUMER'S PROTECTION

Secretary Regan. In general, I think I would agree with the chairman on that. The only thing that I spotted in listening was his failure to emphasize the consumer protection. I think the FDIC and the FSLIC were set up partly for consumer protection, not necessarily just to protect the institution itself. I think that the Federal Reserve System, as I recall it—I wasn't around at the time, although it may seem that way—also was set up partly for consumer protection purposes. It wasn't set up to protect the institution itself. It was set up as a result of panics. There had been the 1907 and subsequent panics that led to the creation of the Federal Reserve System in order to prevent interruption to commerce as a result of bank failures. They wanted to be able to stabilize the banking system and I think that today the Federal Reserve can prevent much of the disruption of failures in the banking system by their ability to handle a situation once it arises.

Senator RIEGLE. I get the sense from listening to Chairman Volcker and cross-examining him on this issue that he perhaps puts more emphasis on the uniqueness of banks, that banks are special and different and part of the way he emphasizes that element of specialness is the fact that we have created special kinds of mechanisms for them in terms of the reserve window at the Federal Reserve, in terms of the special deposit protections and so forth, that we have not done for other kinds of financial institutions.

But I sense that maybe you don't see it quite the same way, that you see those things but you don't seem to put as much emphasis on banks being quite different quite special in that respect from other kinds of financial institutions like American Express and others?

Secretary REGAN. No, we recognize the uniqueness of banks. As a matter of fact, that's why we have been assisting in all of this legislation and that's why we support Senator Garn's bill, so that in order to protect the uniqueness of banks, as they are allowed to get into these ancillary financial endeavors, they be allowed to do so only through the holding company in order to insulate the bank.

In my answer to Senator Hecht's question about the banks, I think we have built up a wall in this bill to insulate the bank against any failure by any other related corporation, either the holding company itself or another subsidiary of the holding company, that might get into difficulties.

Senator RIEGLE. Let me just quickly touch on two other things. Last year when we discussed this, you and I here, I asked the degree to which there was a consensus among the various players in the world of financial institutions on the legislation that's being proposed, and at that time you said to me that you felt there was a substantial consensus, and we talked about that in terms of whether the securities industry was part of that, the insurance people were part of that, the real estate people, and so forth.

Would you say today that there's a substantial consensus behind the legislation or what would be your view on it?

Secretary REGAN. Well, to my disappointment, I've noticed that the industries have hardened their positions as time has gone on and now it's become a turf battle and they are all fighting to protect their own interests. As I said in my prepared remarks, this is, in my judgment, very selfish of these groups. They've got what they have. They don't want anybody else to share in what they have. But they sure as heck would like to get a break and get into somebody else's field.

Senator **Riegle**. So then there is not a consensus?

Secretary **Regan**. There is not a consensus and that's why I'm urging this committee to act as statesman and to put aside these differences and make the rules for all who compete because if we allow the situation to go on where each is fighting to keep his own turf, in another year or two it's going to be so convoluted that we'll never be able to straighten it out.

Senator **Riegle**. Well, let me quickly move to another topic that's very much in the news and that we discussed yesterday also with Chairman Volcker. That's the international debt problem, particularly the Argentine problem.

Would I be correct in assuming that the Treasury Department is spearheading the effort within the administration to deal with that problem, or does the lead responsibility reside elsewhere?

TREASURY/FED CLOSELY MONITORING ARGENTINE SITUATION

Secretary **Regan**. Well, Treasury, as a rule, works with the Fed very closely on these problems and we are at this time working with the Fed monitoring the situation, trying to be as helpful as we can.

Senator **Riegle**. Does it look as if we're going to find an answer here before April 1 or I gather there may be a small spillover in terms of an extra 10-day period that's been mentioned.

Secretary **Regan**. I'd like to clarify that in a moment, Senator. As far as what we see now, my Deputy, Tim McNamar, is just returning from Argentina. I haven't had time to meet with him this morning. We still have an Assistant Secretary of the Treasury down there who is discussing the issue, but there's a lot of movement. Whether or not it's going to gel into something tangible, which means the Argentines getting money to make payments on its debt prior to March 31, I don't know at this point.

Senator **Riegle**. Well, if an answer is not found and they go into arrears here—there's a story, as I'm sure you're aware of, on the front of the New York Times today that says that perhaps you're thinking of easing the rules in terms of——

Secretary **Regan**. I'm glad you brought that up. That's an incorrect reading of what I said yesterday by a reporter who was not present at my press conference when this question was raised. The press conference was not on the Argentine problem but the question was raised during it.

What I said was that if payment is not make by March 31, the loans aren't automatically marked no good on April 1. Before a loan is classified—which may require a provision for possible loss—there is a formal procedure whereby bank regulators meet and consider the extent of impairment because of "country risk." There would be a review period. I suggested it could be something like 10 days in the specific case of Argentina, but I had no idea precisely how long it would be, when these regulators would meet, and the like. The reporter's question referred to whether or not on April 1 all these loans would be marked no good, and I said they would have to wait for that.

This procedure is different from that governing the treatment of interest payments if arrearages exceed 90 days. In such an event the proper accounting technique is to stop accruing interest and to treat it as income only when actually received, and to reverse any previously accrued interest not actually received that had been recorded as income in prior statements. The regulators have adopted this procedure as the appropriate policy, but this policy does not entail a decisionmaking role, other than to check during examinations to make sure it is being followed.

So I would say that the headline in the Times and the story itself misconstrued my remarks. I think the story in the Washington Post, for example, this morning is more nearly correct of our attitude at this point.

We are trying to be helpful, but we're not going to bend any rules.

Senator **Riegle**. So would it be correct to assume then that if an agreement is not found and the appropriate period of time runs out and the payments are not paid, that in fact there would be the normal reclassification as we've done in the past?

Secretary **Regan**. That's absolutely correct, Senator.

Senator **Riegle**. Just one other question if I may, Mr. Chairman. I'm just wondering if there are any other nations that are in the cattle chute here behind Argentina that appear to be heading in the same direction. Are we likely to see this problem again within a matter of weeks or 2 or 3 months with another debtor nation? Is there any sign of that at this point?

Secretary **Regan**. There are other nations. I hate to mention them in public until such time as we actually get there, but there is no doubt that there are several nations, some of them in Latin America, some of them in Africa, which have problems meeting payments on their debt. And unless drastic action is taken by those nations in order to get into conformity with an IMF program, they too, like the Argentines, are going to come up against some type of deadline. Just when that deadline will be, I don't know; but it could happen in a matter of months and then we would have another nation in this same predicament.

Senator **Riegle**. Without naming names, have there been any signals sent from any of the other nations in this condition that maybe they're thinking about doing what Argentina seems to be doing here?

Secretary **Regan**. No, not as yet. There are statements occasionally made by political figures that they don't like the IMF programs. They twist and turn under IMF programs or they can't meet IMF programs or won't because of pending elections in their country, things of that nature, but as yet, no one has suggested that they might default.

Senator **Riegle**. Just one other thing. If Argentina does take this course of action, do you think that's likely to have an impact on the decisionmaking of other debtor nations? Are they likely to be drawn toward the Argentine example?

Secretary **Regan**. Well, I think they will wait to see what happens to Argentina as a result of any such action, and I would state that that would be something that all of us in responsible positions in the industrialized world—not just the United States but all other industrialized countries, particularly those countries whose banks are engaged in lending processes for international trade—would view with very much concern, Senator.

Senator RIEGLE. I thank you, Mr. Secretary.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

Mr. Secretary, I'm sorry I missed your statement. I was just leafing through it. But I gather the principal benefits you see from an expansion of bank powers and a so-called more level playing field are: (1) benefits to the consumer; and (2) what you described as competitive equality. Is that a fair summation?

Secretary REGAN. I would say so, yes, Senator.

Senator HEINZ. You are uniquely placed, given the fact that you have to refinance the national debt all too often, to understand the importance of banks to our economy. How would you describe that which sets banks and depository institutions apart from other institutions—our other financial institutions?

UNIQUE FUNCTIONS OF BANKS

Secretary REGAN. Well, there's no doubt that banks operating as depository collection agencies, as lenders to business and to individuals, perform a unique function in anyone's economy, and the central bank certainly implements through the banking system monetary policy which has an effect on the economy. For this reason, banks have to be treated a little differently than others when you consider what types of endeavors they should be allowed to go into. Different nations treat banks in different ways. The Japanese banks are tied in with trading companies. The German banks are to the same extent. Other nations will not allow their banks to be tied into trading companies. Here in the United States we've always forbidden banks to get into commerce, and this distinction is preserved in the Garn bill. All this is, is an attempt to continue to insulate the banks, keep them from suffering any adverse effects from nonbanking endeavors, but at the same time allow them to get into other aspects of finance, not just banking.

Senator HEINZ. Mr. Secretary, I agree with everything you said, although I would expand upon what you said and, borrowing from what Chairman Volcker said I think quite articulately yesterday, that banks are unique not just because they are used as the vehicle in this country for the conduct of monetary policy, not just because they are the repository of short-term credit which is of vital interest to consumers and businesses, large and small, but even more important than that, they are the heart of the payments system in this country and it is the payments system that the liquidity of everybody is involved with and the banks are indeed the people who are responsible for making sure our payments system actually works and, as a result, as I know you know, we have given banks certain very necessary financial safeguards—the Federal Deposit Insurance and the window at the Fed, the deep pocket—Tim McNamar popularized that phrase on another occasion, but it is what the Federal Reserve window is all about.

Now the question that troubles me is that with respect to competitive equality, how can one establish competitive equality even through a separate subsidiary—and I salute you for being in favor of a separate subsidiary—if the financial parent of the separate subsidiary bases its financial strength, its access to capital, its ability to acquire and invest funds principally as it does under the bank holding company, on banks which have an especially strong and protected position bolstered by Federal Deposit Insurance and also supported, should it ever need it, by the Fed window. Indeed, when Senator Garn had his second hearing—his first was in Utah—the second was here—the witness from the American Bankers Association said in his opening statement, not in response to any question that any of us asked, that banks will not be at risk going into the other areas because the Federal Government will not let them fail. He said that in so many words.

Now if that's true, that doesn't strike me as competitive equality. How do you respond?

MATTER OF BANK FAILURES

Secretary **Regan**. Well, first of all, that statement that you quoted to me is an incorrect one. I just call to your mind Penn Square and First National Midland as recent examples of banks that have failed, even in this day and age, and the Federal Government has allowed them to fail.

Just two weekends ago, there were a couple of other bank failures that were allowed to happen.

Senator **Heinz**. Did it cost us anything?

Secretary **Regan**. No, it did not, if you think in terms of the Federal Deposit Insurance Corporation fund as moneys that have been paid by the banks themselves, not by the people.

Senator **Heinz**. That doesn't show up in the Federal deficit at all when they make a payment?

Secretary **Regan**. No.

Senator **Heinz**. It's free money.

Secretary **Regan**. And as a result, from the point of view of the banking system, the fact that banks can fail should remain one of our cardinal principles, that no one is to be completely protected against failure, against rash acts on the part of management or the directors. I think that banks should be allowed to fail as long as these smaller depositors are protected.

Senator **Heinz**. What about the access to the Fed window?

Secretary **Regan**. The bank itself can have access to the window, but let us suppose that the bank holding company has an insurance affiliate and that insurance affiliate is failing for some reason or another. The bank would not be allowed to bail out that insurance company. There is no provision in the Garn bill that would allow that, and I——

Senator **Heinz**. Can you hold it right there? I don't want us to talk past each other on this. You're saying banks can fail and I'm not contending that they can't fail. I suppose it would be accurate to say that I'm contending that it's a lot more difficult for a bank to fail because we don't like to see them fail.

Secretary **Regan**. I'd agree with that.

Senator **Heinz**. And that's really the point, not whether they do or don't. Then I don't think we have an argument on that point.

Now do we have any argument on the point that the financial strength, whether we help the bank or not achieve that strength, is the principal basis for a bank holding company having access to the market for capital? Do we have any disagreement on that assertion of mine?

Secretary REGAN. Let me have that once more.

Senator HEINZ. Do we have any disagreement that the underlying asset of the bank holding company, namely the federally insured bank, is the reason the bank holding company can go out and sell stock, borrow funds, issue convertible preferred, issue preferred, issue these new convertible borrowing notes to improve their capital ratios that have been so much in vogue—isn't that all because bank holding companies have a very valuable asset called a bank?

Secretary REGAN. We are in agreement on that.

Senator HEINZ. All right. Then I think you have probably answered my question, at least to my satisfaction, because what that means to me—and I don't wish to put these words in your mouth and this is an expression of my interpretation—there is an asset; it has certain advantages from the Federal Government; it allows bank holding companies to raise money which bank holding companies can invest in these other industries; and it seems to me that this should raise some questions to us on the issue of whether that is competitively equal.

When a bank holding company raises money, they go into the market. It would seem logical to me that they, because of what I've just described, have a somewhat preferred position when they go to borrow in the market because of their financial strength, and the lines of business—the powers that we would give them, by and large, those people they would be competing with would not appear to be necessarily so advantaged. Even Sears Roebuck doesn't have any federally insured subsidiary with access to the Federal Reserve window that they can point to when they go to market. Is that right?

Secretary REGAN. Well, if you take a look at all of these organizations around here on the wall, every one of them owns a bank. Now if Sears Roebuck is issuing stock or bonds or what have you, I'm not sure it's because of the underlying bank that people would be buying Sears' securities. And if a bank——

Senator HEINZ. In Sears' case, their S&L is a fairly small part of their operation so far.

Secretary REGAN. Yes, but a bank holding company doesn't have to own a large bank. It could be a very small bank, like E. F. Hutton's. So all bank holding companies are not exactly homogeneous.

At the same time, under the Garn bill, the bank would not be allowed to make good any loss in the holding company. So if the holding company were failing and it couldn't pay the interest on its debt, the bank couldn't get up the money in order to pay it.

Senator HEINZ. But could the holding company go to the market, get money, and give it to the subsidiary?

Secretary REGAN. Yes.

Senator HEINZ. If I may just pursue that point, there comes a point at which if the subsidiary is not doing too well and the holding company keeps going to market, the market is going to say either stop or raise the price to the holding company.

Were that hypothetical to take place, would that impair the ability of the bank, whose safety and soundness we all care so much about, to raise capital?

DISTINCTION OF BANK'S DEBTS

Secretary **REGAN**. It shouldn't because if the bank issues its own debt, then those holding the debt would look to the bank itself for payment, not to the holding company or any other company in the organization.

Senator **HEINZ**. Would the issuance by a bank of debt improve the capital position of the bank?

Secretary **REGAN**. Yes.

Senator **HEINZ**. If it were plain debt, I would think it would have no effect on the capital position.

Secretary **REGAN**. If it were a convertible or something of that nature.

Senator **HEINZ**. Well, now you're talking about equity. A convertible bond is part debt and part equity because it's convertible into common shares. Do we know of any instances where banks that are owned by bank holding companies actually issue in some form equity?

Secretary **REGAN**. Equity?

Senator **HEINZ**. Equity.

Secretary **REGAN**. No. We have never heard of anyone issuing equity. A bank being a subsidary company of a holding company is usually 100 percent owned.

Senator **HEINZ**. That's the point, exactly. And therefore, if they issue debt, they create a liability as big as the asset and their capital ratio, Mr. Secretary, is not changed by the issuance of that debt. Capital for a bank can only be augmented either by earnings or by the issuance of common stock or its equivalent—preferred stock—in the form of subscribing to additional capital for that bank.

So I really believe the answer to the question I proposed, as to whether the weakened position of a bank holding company would jeopardize the financial ability of its wholly owned bank subsidiary to acquire capital, that the answer to that question would be yes, or so I would think based on what you just said.

Secretary **REGAN**. Well, to acquire capital, but what would the capital be used for? I'm not following your point.

Senator **HEINZ**. All right. Let me explain. Some banks have made doubtful overseas loans and when they make doubtful overseas loans sometimes those loans become classified. This is the great fear about Argentina which has until the end of this month to decide whether they are going to make good on their interest payments, and if they don't, the bank will be forced to list their loans as nonperforming and a certain portion of those loans will be charged against capital under the IMF reform bill that we passed.

Secretary **REGAN**. Not the loan. The interest payment. Currently you have to wait for 6 months before that. This is only 90 days. The loan is the next step.

Senator HEINZ. That is correct. But eventually, if there is a pattern of nonperformance, the capital of the bank will be reduced.

Now at the same time as the capital of the banks are being reduced, the Federal Reserve and others have implemented requirements to raise the capital ratios, particularly of the money center banks. It is very important that money center banks do not operate with 3 or 4 percent of capital when they are lending 3, 4, or 5 percent of their capital to one shaky international lender. At least that was the judgment that people seemed to share a few months ago.

So the capital of the bank is quite important, and indeed, if you went to the money center banks in New York City you would find that during the last 6 months to 1 year they have all had to increase their capital—most of them, maybe not all—because the Federal Reserve has told them that they had to.

Secretary REGAN. That's correct. The Federal Reserve adopted a 5-percent rule. But as to one statement you made—it doesn't necessarily follow, if there is a nonperforming loan and there's a hit to the bank, that the capital is impaired. They do have reserves and the hit goes against the reserves first.

Senator HEINZ. That is right. Obviously, there is a cushion.

Secretary REGAN. And depending upon how much the bank has in reserves——

Senator HEINZ. Mr. Secretary, you're absolutely correct, but I think we're both agreeing on the same principle, which is that there comes a point at which the bank's capital clearly does become impaired and at which point the significance of the financial condition of the holding company is pertinent.

I apologize. My time has expired and I have gone over my time and I apologize both to you and to my fellow Senators and maybe we would have a chance to continue this when people have another round.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Mr. Secretary, yesterday Chairman Volcker suggested that the Congress forbid States from granting State-chartered banks those powers denied to national banks or bank holding companies because of our decision that they are inappropriate for safety and soundness reasons.

The Chairman suggested that we should continue to permit States to decide for themselves among powers which simply raise concerns of anticompetitive behavior as against safety and soundness.

Could you give me your views on that suggestion? In other words, should the Federal Government take a stronger role in overseeing the powers of State-chartered banks?

DUAL BANKING SYSTEM HAS SERVED THE NATION WELL

Secretary REGAN. I don't think so, Senator. I think that the dual banking system in the United States has served us well. As one who believes in States rights, I don't think that the Federal Government should override the States unless there's something really wrong that a State has done. The fact that a State differs in a practice is no reason for the Federal Government to step in.

Senator **Gorton**. So you would not limit in any respect beyond what we already do on the activity of the State-chartered banks?

Secretary **Regan**. That's right. I would add, however, that as the States allow more and more things to happen in the financial services area, the Congress should take the lead by saying what any bank can do or cannot do through a holding company and make the rules that way rather than limiting the activities of State banks. That's what this Garn bill is all about and that's why we support it.

Senator **Gorton**. Thank you.

Last week, FDIC Chairman Isaac proposed a different definition of a bank, essentially defining as a bank any institution which called itself such, and he proposed that such institutions should be required to be FDIC insured and regulated as banks and that no institution which did not call itself a bank should in turn be eligible for such insurance.

Can you comment on that suggestion?

Secretary **Regan**. Well, again, I think the Congress is going to have to make a rule as to what a bank is, and our suggestion would be that institutions that have FDIC-insured deposits should certainly be included in the definition of a bank whether or not they make commercial loans.

Senator **Gorton**. That sounds very much like his proposed definition. Thank you.

Thank you, Mr. Chairman.

The **Chairman**. Senator Lautenberg.

Senator **Lautenberg**. I'm sorry to come in so late, Mr. Chairman. I appreciate the opportunity to meet with the Secretary and just very briefly I heard you respond to Senator Gorton's inquiry on how much we ought to involve ourselves at the Federal level in State-chartered institutions, and you responded with a States rights view.

Does that also apply to the South Dakota situation in your view?

Secretary **Regan**. Well, I think that the Congress should try to make a rule as to whether or not it wants banks to be able to get into the insurance business and if they do they should permit it for all bank holding companies. They shouldn't just say no to South Dakota.

And by the way, Senator, there are three other States besides South Dakota that now permit insurance activities.

Senator **Lautenberg**. Right. But South Dakota was the beginning of the process and, of course, our linkage at the Federal level I believe is through the insurance program, the FDIC. You define that as an integral part of the definition of a bank and therefore then I think it suggests that if that's part of identifying a bank, then therefore it suggests that we have a responsibility to try to help determine what activities these folks are going to be involved in and what the connection might be one State to another, interstate commerce in banking. It would seem to me that we have to play a role if we're going to insure those deposits.

Secretary **Regan**. Well, I think from the point of view of the banking system itself, if you're suggesting there should be only one banking system and that's the national banking system, I disagree.

I think the States should be allowed to have their own banks. The dual system has worked, and I don't see anything wrong with it.

Senator **Lautenberg**. Without spending too much time on this issue, if you take the States' rights viewpoint, then you're saying, regardless of what the practice is now—and I'll leave South Dakota for a moment—whether there are reduced responsibilities in one State to try and attract banking business, tax incentives and so forth doesn't concern you in terms of the safety and security of the depositor or the bank customer in any way. Again, you feel there ought to be a hands-off thing wherever possible.

Secretary **Regan**. No. I'm urging the Garn bill which would take the pressure off the States. The Garn bill would establish rules under which banks could get into these ancillary types of businesses. If we don't do that, then chaos will result because any State can do it without these rules. As I said in my prepared remarks, a group designed for the purpose of looking into whether or not New York banks should be allowed in the insurance business has reported favorably to the New York Banking Superintendent that they indeed should be allowed in. If the New York banks are permitted to go into the insurance business, I submit that most of the banks that are located in New York City, most of our large banks, will indeed become State banks for that purpose. I see no reason why they should be forced to leave the national system in order to get into that business.

Senator **Lautenberg**. What I sense, Mr. Secretary, is that it's a States' rights philosophy to a point. That is, I don't think that you really want to step away from some Federal monitoring supervision, and so forth..

Secretary **Regan**. That's right. I think that's why I'm urging the Garn bill. I'd rather see the rules made at the national level so that everyone would be competing equally rather than just having it develop haphazardly from State to State.

Senator **Lautenberg**. That sounds to me a little bit different response from what I think I heard you say to Senator Gorton.

Again, I'm sorry, if there's been anything repetitive, Mr. Chairman, let me know.

The list of nonbank companies that own banks—funny enough, I used to serve on the board of one of these and competed with another and you and I had all kinds of pregovernment business contacts, you more splendidly than me, but at what point are you at in terms of permitting this or encouraging this practice to continue, the nonbank entry—there's one there, Merrill Lynch—in terms of continuing their expansion in the banking field?

ALLOW BANKS TO COMPETE UNDER PROPER CIRCUMSTANCES

Secretary **Regan**. Well, what I'm urging is a slightly different fix on that. I'm urging that the bank be allowed to compete with Merrill Lynch rather than that Merrill Lynch be allowed to compete with the bank.

Senator **Lautenberg**. Just Merrill Lynch.

Secretary **Regan**. Or anyone else of that nature, if there is anyone else of that nature.

I would say, Senator, all of these companies, be they insurance companies, or retailing companies, or what have you, are trying to get into some phase of the banking business. Why shouldn't the bank be allowed to get into some phase of their financial services under proper circumstances, and I happen to think the proper circumstance is through a subsidiary of a holding company, not directly as part of the bank. I think we should have antitying provisions and protection against the holding company or any subsidiary using the bank to bail itself out. But if we have those safeguards, I see no harm in allowing the banks, if they choose, to get into these other businesses.

Senator LAUTENBERG. Ergo, no prohibitions on keeping this variety of companies from getting into the banking business?

Secretary REGAN. That is correct.

Senator LAUTENBERG. Would you encourage that?

Secretary REGAN. Again, under the same requirement that they do it through a holding company so that the bank itself is insulated.

Senator LAUTENBERG. I think Chairman Volcker wanted a number of restrictions on transactions among subsidiary holding company affiliates. His suggestion included, as I understand it, prohibiting the use of a common name, prohibiting essentially the credit from banking affiliates. What do you think of those kinds of restrictions?

Secretary REGAN. Well, I have only had a brief opportunity to review his testimony because I just returned from China yesterday. I didn't have a chance to talk to him before he testified. Most of what he said I think I could go along with. I'm not sure about the common name prohibition, but in general I think most of his recommendations are sensible.

Senator LAUTENBERG. I'm terribly troubled and concerned about tie-in relationships and when I was in the computer business, financing the computer company that owned a bank, but that was always a intimidation of the customer by the bank who chose to use it conveniently just by name, by business practice, what have you. And very recently there were ads appearing in the New York Times that talked about payroll preparation by one of the country's five largest banks—that narrows it down pretty much—a little more and I'll tell you who it is. They said in their ad, not that they could do the work better, do the work cheaper, more efficiently, whatever; they simply said, "After all, we're Bank America"—it's no secret since this was all over the newspapers—"We're Bank America and one of the world's largest banks and we know how to do things well." And it was that kind of thing and I don't mean to pick on them particularly, but it's that kind of tying, that kind of coercion that comes from just sheer magnitude of exposure and presence that concerns me, and that's why I think we have to move very far away from any identification with the parent or the founding company or the founding bank's name. I just think that it does present an unfair competitive advantage for the bank.

Does that concern you in any way, the indirect coercion that comes in? I think if we use the Volcker principle or something fairly close thereto, just eliminating any connection—if it has to be that way I'd almost recommend separate facilities, et cetera.

Secretary **Regan**. Well, I think fences can be put around the individual enterprises so that overreaching is not permitted by a bank using its muscle to coerce a customer into accepting some other type of service, but I wouldn't want to see that prevent the bank holding company from being able to offer that service if it chose to get into that particular business.

Senator **Lautenberg**. Thank you, Mr. Chairman. My time is up.

The **Chairman**. Mr. Secretary, both Senator Heinz and Senator Riegle questioned you at great length about the safety and soundness and what additional powers will do for the banks and about the uniqueness of the banking institution, and I would agree with both of them and with Chairman Volcker yesterday, that banks do have a unique position. I don't think anybody could argue that they do not, compared to other types of firms. So we do have a responsibility for those who deposit money with them to do as much as we can to insure the safety and soundness of those deposits. So that does place them in a unique position.

However, even though I agree with that, through all these hearings, as Chairman Volcker said yesterday, more than 44 hearings, 245 witnesses, 7,000 pages of testimony, there has been an overriding argument among those who oppose any expansion of bank powers to fall back on the argument that I agree with and has been stated here today, that they are unique and therefore they must not take these unnecessary risks.

These are the same self-righteous people who had no concern whatsoever about the safety and soundness and as in past years they have tried to get into every phase of the banking business they could—take their deposits to New York, Chicago, and Eurodollars, and so on. There's just one hell of a double standard among those who have testified before this committee and using it to oppose. That's pure, plain protectionism. That's all it is because they went into the money market funds—and I'm sorry, I'm sure you were not terribly concerned about the safety and soundness of the banks when you invented CMA's. You saw a way in which to better make Merrill Lynch a profitmaking organization and suck up a bunch of funds out of my banks in Utah, Nevada, and all over the country.

Secretary **Regan**. Well, I prefer to use the word "compete with." [Laughter.]

The **Chairman**. Well, whatever term we're going to use, I've sat through a lot of hearings the last few years and I don't mean to just single you out, but those who oppose do fall back on the safety and soundness argument in which they are correct, but they didn't care about that and they don't really care about that now as long as they keep the banks out so they can roll on.

TWO WAYS TO PROCEED TO CREATE EQUITY

So it gets back to a statement that I made at the very beginning in my service on this committee, a long time before I was chairman—there are two ways to proceed in solving competitive inequities and lack of equality created by Government rules and regulations. I chose early in this game several years ago on a very limited basis—not talking about banks and savings and loans getting into general commerce or buying retail stores or anything else—but a very limited extension under very strict conditions of some competitive equity in some of these areas, not full securities, not any of the things that some people would like to believe, but very limited expansion of powers which this bill still does.

The other choice was to stop all this. And I chose, with my free enterprise market experience, to say no; we've got an industry that is overly regulated now by rules and regulations that were undoubtedly valid at the time 50 years or so ago when they came up. But I want the message to go out very loud and clear, I'm sick and tired of greed, selfishness, and protectionism wherever it comes from. As long as I'm chairman of this committee, we will try to have some equity and if it fails, if we are not able to go ahead with some limited expansion so that these who so profess to be so concerned about safety and soundness and the consumer as long as they are protected, as long as they can participate in bank-like services and do things that traditionally were never even thought of, but if we have this continued type of one-sided selfish greed opposition, while they want to go merrily along, then the issue of divestiture becomes very real even to one who does not like that. It won't be just a matter of changing the bank definition of what it is to stop future action. This Senator will turn around because I will not tolerate this kind of inequity and unfairness.

I'm really getting to the point where I don't care which way it's solved, but if I can do anything about it, it will be solved. Government will not be the engine of giving parts of the private sector competitive advantage over another. If the rules are the same, however those rules are set out, and Merrill Lynch can beat the hell out of a bank or a savings and loan, so be it. If the rules are the same and the competitive equities are the same and a bank can beat the hell out of Travelers or Sears or anybody else, so be it. If they fail on either side, so be it. If they have to be merged, so be it, as long as they're operating under the same rules. But they are not, they have not, and there are competitive inequities due to government.

Now, having made my speech about one way or another, I will try to push this committee to solve it. What do you think about divestiture? Do you think that's a good route to go to? There's a list the Chairman gave us yesterday, a long list—tell Prudential to sell Bache, fine; get American Express out of Shearson. Tell Merrill Lynch to give up their bank and Sears to get rid of their savings bank.

I can't emphasize strongly enough that there are two ways to go and I chose what I thought was the fair and reasonable way to go in the marketplace of the 1980's, not the marketplace of the 1930's, but there is another route. If anybody wants to take this as a threat, they can take it any way they want, but I repeat, as the Senator from Pennsylvania said yesterday about motivation and greed—and he was correct—and turf protection and so on, I'm getting to the point where I really don't care where it falls.

Senator **Heinz**. But don't you think you're being a little harsh on Merrill Lynch?

Secretary **Regan**. Let Merrill Lynch defend itself.

The CHAIRMAN. I am letting Merrill Lynch ride with all of the others.

Senator LAUTENBERG. You're going to have to defend the Secretary here.

The CHAIRMAN. He is perfectly capable of defending himself, as I have found out over the years.

Secretary REGAN. May I say something here at this point, gentlemen? I feel that Senator Garn is on the right track with the Garn bill. I would hate to see us step back from this bill and get into divestiture and trying to put everybody back into neat little boxes where they might have been 50 years ago. The world has changed. The world is going to change even more. We're getting close to the 21st century. People no longer shop the way they used to. People no longer use the same methods of transportation they used to use.

I keep using this as a favorite example. When the McFadden Act was passed, the Senators in those days had every reason to believe that they were doing something good for local banks. But if you think in terms of what was the greatest scientific achievement of the year in which the McFadden Act was passed, it had to be Lindbergh crossing the Atlantic.

Now I've just come back 10,000 miles in some 20 hours from China and Japan and I didn't think that was a scientific achievement but I welcomed the achievement. So you have to think to yourself, now in the days of electronic funds transfer, the days of supercomputers, and things of that nature, are we right in going along with these antiquated rules or not?

OVERALL GOOD IS THAT CONSUMERS ARE BENEFITING

I think that we have to look at the overall good. I'd hate to see us step back and try to undo what has already been done. I think that what these firms have been able to create they should be allowed to stick with, and I think if others can be more creative, fine. Who's benefiting? The consumers are benefiting. Who's hurt? Vested interests are hurt and I recognize that. But again, I hate to give my speech, but this is capitalism in action and capitalism certainly means competition and not protectionism.

So I would urge that you, Mr. Chairman, not back off from your bill, but instead, get on with your markup and try to get it passed with the help of the rest of these Senators.

The CHAIRMAN. Well, let me say that I completely agree with you. I have outlined for a number of years ad nauseum what my choices are and which direction to go and you said there were three choices. First, you can continue to do nothing. That is an option that I think is the worst choice of all because the marketplace will continue to change in an ever more rapid rate and Congress will not be able to escape the blame for not being willing to face up to the issues.

Second, you can require financial and nonfinancial companies in States to turn back the hands of time. I don't prefer that one either. That is as foreign to my political philosopy as it's possible to be—retroactivity, turning back the clock on those who in good faith have made investments.

Third, you can enact legislation. That's what I think we ought to do. You said it yourself in your testimony today, some of the attitudes have hardened. Well, attitudes have hardened in both directions. In trying for 3 or 4 years to move this process along, without any pride of authorship—and I've stated it in every single hearing—I make no claim to any particular provision that I care whether it stays in or not, but a package, as Chairman Volcker talked about yesterday, should be moving ahead in a positive way and having this committee and this Congress make decisions, whatever those decisions are, what other limitations we wish to place. But if those out there in the marketplace who are hardening their attitudes and want nothing, I think nothing is the worst of all of the alternatives because then we will have the aberrations that every single witness has talked about of the States, of the regulators, and the free market coming up with a great deal more new and difficult problems than we're facing today.

Don't misunderstand my comments at all about backing off the approach I have taken. I'm just saying that if it fails—I have not backed off 1 inch. I'm not the type of person who backs off when I think there's a right course to go. Then I think these people who are hardening their attitudes know they can harden on the other side and divestiture is a better alternative than doing nothing. It's objectionable to me, very objectionable, but less than Congress sitting on its can unwilling for whatever reason to make some decisions that, as you said, step on toes. Well, there are a lot of toes in this financial marketplace that need to be stepped on. There's no doubt about that.

So I hope that is not the alternative that we come to, but I just once again had to point out the double standard of those who testify before us about safety and soundness, which again I reiterate I agree with them is important, probably the most important thing this committee does, with 14,500 banks, thrifts, credit unions, and all that, it may be our most important function, and banks are unique. I agree with Senator Riegle and Senator Heinz totally. They are different than Sears, Merrill Lynch, and so on.

But those people cannot make that argument who sit in the place you have sat in today and then immediately, if we did nothing, go on raiding the till in bank-like services with no concern whatsoever. There's a lot of rhetoric that goes on, not just from politicians but from people who appear from the private sector as well. They have learned the rhetorical game. Maybe they ought to go into politics. They come along well in saying one thing that sounds great and rings true, but they don't really mean it, they don't really care as long as they seek protection from competition from Government as they go to the Kiwanis Club and the Chamber of Commerce and beat themselves on the chest and give their free enterprise speech how they believe about free and fair trade, as long as it is not free and fair for them and they get advantage from the Government.

Well, I think I've used my questioning period with a speech. Senator Hecht.

Senator HECHT. I thought it was very eloquent and I enjoyed it. Just one thing, Mr. Secretary. I admire your stamina in just getting off the plane from China and being so alert and everything.

But may I just ask you one question about China? Do you see them as a major trading partner of America in the next few years?

CHINA AS A MAJOR TRADING PARTNER

Secretary **Regan**. Yes, I do. They are trying to open up their market. I initialed a tax treaty while I was over there so that American companies going over there will know the tax consequences of their action. There's a group from China in Washington this week trying to finalize an investments treaty. Hopefully that also will be ready for signature by the time the President gets to China.

When those two agreements are signed, I think that that would really open up the doors for our companies to go into China, knowing that they have some protection as far as legalities are concerned, and at the same time, they are at risk as far as whether or not they can have a profitable venture. But that's the essence of what they want.

China has 1 billion people. It needs an awful lot of things and I think we can supply an awful lot of them.

Senator **Hecht**. What companies would be first to go?

Secretary **Regan**. I suspect oil companies and light manufacturing companies would be the first ones.

Senator **Hecht**. I've heard many stories about the Chinese oil reserves. Would you comment on that?

Secretary **Regan**. Well, their reserves on land are not that great. There is a great possibility that offshore, particularly in South China, there is much oil to be found, and that's where most of the exploration is going on.

Senator **Hecht**. Is there quite a bit right now?

Secretary **Regan**. Yes. There are several companies exploring now. A lot more will go there as China opens up the acreage for them to explore.

Senator **Hecht**. Are there any other comments before I close off on China?

Secretary **Regan**. Well, I would say that they are moving somewhat away from their rigid communistic ideas as to how industry should be handled. They're moving more toward an incentive system. I think that bodes well for the future as they move from rigidity more toward not an open market but at least a more competitive atmosphere.

Senator **Hecht**. Do you feel that we can do business with China and also with Taiwan?

Secretary **Regan**. Yes.

Senator **Hecht**. No problem?

Secretary **Regan**. There will be problems, but I think we can do business with both. I don't think we have to turn our back on Taiwan because we are doing business with the People's Republic.

Senator **Hecht**. Was there any criticism from Taiwan when you went to China?

Secretary **Regan**. If there was, I didn't hear it and it hasn't been brought to my attention.

Senator **Hecht**. Thank you, Mr. Secretary.

Chairman Garn, no further questions.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

Mr. Secretary, you have been very patient for the committee and I just second what Senator Hecht said about your trip to China. I'm glad you made it and hope it was really totally successful and I'm glad you were well accompanied and I thank you for all your help with a number of things; but I'd like to spend just a moment on the question of consumer benefits.

It would seem self-evident to me—that if there is plenty of competition in an industry that the consumer is benefiting and that simply having more competitors once you get past a certain point doesn't have much effect on consumer benefits. It has an effect perhaps on the people who are competing. This at least seems to be the theory of the Justice Department with respect to oil mergers wherein they have decided that if you take two large oil companies and merge them—there is certainly no effect on competition, at least that they seem to be able to discern. And I assume that it holds true for these other industries.

Now typically, the argument over bank powers seems to concern either the brokerage and/or the underwritting or development of insurance, real estate, and securities principally. Where in that list is there a lack of competition?

Secretary REGAN. Well, there's plenty of competition. Whether or not the entry of a bank would provide more competition, of course, is open to argument.

Senator HEINZ. There's no doubt there will be more competition, but I'm just wondering whether there will be any significant additional consumer benefit from having more competitors just using the current theory of the Reagan administration's Justice Department.

BANKS ENTRY INTO THE FULL LINE OF NEW WAYS BENEFICIAL TO CONSUMERS

Secretary REGAN. I think that there would be more benefits to the consumer. First of all, none of us knows at this point how many new financial instruments or new ways of doing financial business could be conceived by the banks as they get into the business. When you're a new entrant into a business you have to have something different in order to make your presence felt. Witness the American Telephone Co. getting into the computer business. You have to come in with something new, different, cheaper, better, or else you're going to fail.

The banks, knowing that, would have to come up with something cheaper, better, what have you, as they entered new businesses. Who would benefit? Consumers would benefit.

In addition, there are an awful lot of new technological innovations coming about these days. The brokers don't have the last word on that. There are many innovations that could come from the banking side of the financial service industry because banks are more sophisticated in computers than most of the brokerage firms.

Senator **Heinz**. Except insofar as 10 percent withholding was concerned which was an impossibility in the banks' view, we were told.

Secretary **Regan**. But they're performing pretty well on 1099's.

Senator **Heinz**. Let's not bring up echoes of the past.

Secretary **Regan**. Let's make it 20 percent and I'll go with you.

Senator **Heinz**. Mr. Secretary, you don't want to get into that fight in an election year.

Secretary **Regan**. I know.

Senator **Lautenberg**. I'd like to.

Secretary **Regan**. We're doing all right with the 1099's.

Senator **Heinz**. Mr. Secretary, to return to the question, banks account for roughly $2.3 trillion in sum of the assets in the United States. You were kind enough to bring with you, I assume, the names of some very substantial financial and nonfinancial institutions—J. C. Penney, Travelers, Merrill Lynch, Gulf and Western, and so forth, a very impressive list. I assume that were one to add up the assets of all the retailers, insurance people, securities, communications, financial services, manufacturing, and other industries that you have laid out before us that we would have a pool of assets that would be substantially larger by many, many magnitudes than $2.3 trillion. Is that right?

Secretary **Regan**. I'm not sure. Going over it mentally, I'm not sure what the total assets of Prudential, and Aetna, and so on would be. It would be in the insurance industry where these assets would be large.

Senator **Heinz**. Well, I wasn't limiting my question just to insurance. I was limiting it to all the rest of the economy. What are the total assets of the American economy, exclusive of the $2.3 trillion?

Secretary **Regan**. I have no idea, frankly.

Senator **Heinz**. I should not have asked our chief financial officer such an embarrassing question.

Secretary **Regan**. It's not an embarrassing question. I think it's an impossible question, but we will try to find out for the record.

[The following information is supplied for the record.]

Answer to Senator Heinz' Question about Nonbanking Assets in the Economy

Question

What are the total assets of the American economy, exclusive of the $2.3 trillion of assets held by banks and savings and loan associations?

Answer

There were approximately $22.2 trillion of total assets (business, household and government) in the U.S. economy at year-end 1982, or $19.9 trillion excluding bank and S&L assets.*

The following is an approximate breakdown of nonfarm business assets in the U.S. economy at year-end 1982. Total nonfarm business assets excluding bank and S&L assets were 3-1/2 times the amount of bank and S&L assets.

	Market Value ($ Trillions)		
Financial assets			
Private nonbank financial institutions		2.9	
Commercial banks		1.6	
Nonfinancial businesses			
Nonfarm noncorporate businesses	.1		
Nonfarm corporate businesses	1.1		
Total nonfinancial businesses		1.2	
Total financial assets			5.7
Tangible assets of nonfarm businesses and corporations			4.6
Total nonfarm business assets			10.3
Total nonfarm business assets less $2.3 trillion of bank and S&L assets			8.0

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* All figures are from the Federal Reserve's Flow of Funds Accounts. Government tangible assets were not included in the Fed's data.

Senator HEINZ. I suppose there's a way of working it out somehow, but I suspect it's a good deal larger than $2.3 trillion.

Secretary REGAN. I suspect so, particularly since our gross national product is around $3.5 trillion.

Senator HEINZ. But I'm talking about assets and that's in a sense kind of a return on assets, I hope.

In any event, my question is, should it turn out that all these other industries are very willing to compete to provide certain kinds of financial services short of deposit taking to customers, I think we would both agree that ultimately there's not going to be any lack of competition.

So let me ask you this. Is one of the reasons that we should seriously consider granting banks additional powers is that in some way they financially need them to be strong and survive? Is that an argument here or do they not need them to be strong and survive?

Secretary REGAN. What's puzzling is the word "survive." I think we can have a banking system without——

Senator HEINZ. To be strong and prosper?

Secretary REGAN. That I would agree with. They need this.

Senator HEINZ. They do or don't need this?

Secretary REGAN. They do need this. I think if they are restricted strictly to banking over the years, while they will be prosperous, they won't be nearly as prosperous as they would be with these additional powers.

Senator HEINZ. Let me read you the Wall Street Journal today. I'm sure you've read it but I'll read it for the record. It says:

> Without the rise in loan losses, the banks 1983 income before securities transactions would have increased plus 6 percent for 1982 and 22 percent from 1981, assuming a typical effective tax rate of 13 percent.

As it was—this is not in the article where I'm about to place it—"income before securities transactions was minus 3.3 percent." The article goes on to say:

> All the earnings declines appear to stem from loan losses. The industry's basic profit margin, the difference between interest rates and the banks' cost of funds, was 3.92 percent in 1983, down only slightly from 1982 and well above the average for the past 5 years.

Senator Garn should take a great deal of credit for that, thanks to Garn-St Germain.

> The number of banks declined by only one from 1982.

So these statistics would appear to suggest that banks are doing pretty well without any additional powers and to the extent that they are having any problems, they've gotten themselves overextended.

Would you read those statistics the same way?

Secretary REGAN. Yes, but on the other hand, I don't see why the Federal Government should say that the banks shouldn't be allowed to get into other prosperous segments of their own financial services industry, unless they're going to say to these other companies the same thing. Why not restrict them to where they're going?

Senator HEINZ. Mr. Secretary, I think if we say to the banks, "You can't go into these other areas," we should say to the people who you've listed up there that they can't go into banking. There's no disagreement on that. We haven't made that decision, but just so our communications are clear on that point, I think that's a well-taken point.

But let me ask you this. What evidence, if banks need additional powers to prosper, is there that that is a plausible argument, if indeed they are doing pretty well now and seem to be doing better than at any time in the last 5, 6 or 7 years?

FREE SOCIETY ALLOWS DIVERSIFICATION

Secretary REGAN. Well, I think it's for the same reason that these companies on the boards have been allowed to diversify. Prudential is prosperous. Why was it allowed to buy Bache? It's a free society. You're allowed to move from one segment of the industry into the other.

Senator HEINZ. That is a reason—it's a perfectly legitimate reason for allowing powers, but it is not a response, I don't think, Mr. Secretary, with all due respect to my question, which is, if the issue we're talking about, notwithstanding your legitimate argument that let people go out there and compete—just leaving that one aside, if the question is, banks need these powers in order to prosper, as opposed to benefit the consumer, as opposed to compete, as opposed to all kinds of other reasons, is there any evidence to rebut the Wall Street Journal's analysis that says that they are not going to prosper if we don't give them these powers? Because the Wall Street Journal article and the statistics that they have brought forth would appear to support the contention that banks are going to do well, are doing well without the additional powers. Where is the evidence on the other side?

Secretary REGAN. Suppose we have a recession, Senator, starting in 1985. Will the banks prosper in 1985?

Senator HEINZ. Nobody would prosper.

Secretary REGAN. To the extent that the banks have no money to lend. There are any number of possibilities. One would have to be a bank analyst to try to answer your question as to whether banks will prosper in the future, and under what set of circumstances. You would have to know the circumstances. You just can't say yes they will or no they won't. If this recovery continues, the money supply is adequate, the banks will continue to be prosperous. Other phases of the financial business can be prosperous at times when banks are not so prosperous and vice versa. That's why you have diversification. Diversification is an element that hasn't surfaced here yet. Why shouldn't the banks be allowed to diversify their sources of earnings, rather than being restricted to just one source?

Senator HEINZ. My time has expired but I think you've raised a very important question and, with my colleagues' permission, I'd like to explore it for about 15 seconds.

If the rationale for expanded bank powers is to diversify them so that they do not experience earnings declines of the kind that they sometimes experience, that if we agree to that principle, the other side of that coin is to say that we do not need to provide them with the Fed window, we do not need to provide them with Federal deposit insurance, because we have solved their problems. Would you agree with that?

Secretary **Regan**. No, I wouldn't, for this reason. Again, it comes back to the uniqueness of banks which has been the subject of much discussion here this morning. You would want the Fed window in the event the bank needed it if faced with some disaster or near disaster. So you couldn't just say that we're doing away with that.

All of these other firms are getting into banking and into other types of activities in order to diversify their earnings, in order to smooth out their earnings pattern from peak to valley. What I'm saying is that it will benefit the consumer to do this but, in addition, it will allow the banks to diversify their earnings and smooth them out.

Senator **Heinz**. Mr. Secretary, I thank you for being a very willing witness and one that has survived the rigors of his very difficult travel schedule absolutely uncreased.

Secretary **Regan**. Thank you, Senator.

The **Chairman**. Senator Lautenberg.

Senator **Lautenberg**. Thank you, Mr. Chairman.

I want to go on public record as being against greed, selfishness, and protectionism and all those other things as well.

The **Chairman**. Now that you've left the business world?

Senator **Lautenberg**. I think that you will find if you ever look at my business record——

Senator **Heinz**. There may be a majority of the Members in the room whose background was not in public service before they came to the Senate.

The **Chairman**. Mine, as well.

Senator **Lautenberg**. Amen, brother.

The **Chairman**. I was one of those greedy insurance men.

Senator **Lautenberg**. I want to use my time efficiently.

The **Chairman**. Your time has not started yet, Senator.

Senator **Lautenberg**. That's one thing about the chairman, he is always fair—most of the time. [Laughter.]

The thing that surprises me very honestly, to get serious about a very serious subject, is the total abandonment of the special role that banks have in our society and I heard you talk about change and you related it to the flight of the airplane and, Mr. Secretary, I know you too well to attribute whimsy to you, but when you talked about change, change for change sake isn't obviously the primary motivation, I would have to believe. We've seen a major change take place in our society in the industrial complex of our being, and obviously that full measure has not yet been felt. We don't know what's going to happen finally with the AT&T breakup. Frankly, as it stands so far, it's been terrible. I mean the result, it costs everybody more money to do business and service has declined and it's a very complicated thing for most consumers to understand.

NEW ROLES OF BANKS WILL HURT CONSUMERS

And when I look at banking, I see the best housed Nation, more construction per citizen than any other country in the world, stimulated by perhaps what could be described as a benevolent banking situation but, nevertheless, we cannot ignore the product of the system as it existed for so many years. And change is now upon us and it's pretty easy to project that the housing situation will be considerably different than we have known it in the past. As a matter of fact, it's my view that it will never return to what it used to be. The individual home is not going to be the same part of our living mode as it used to be.

I read your statement with interest and we talk constantly about the profit motive, which I think is a darned good one in our society, but I do believe that banks have a special role as has been expressed by my colleagues here, and that it's just not another business. It's not an insurance business. It's not a retail business. It's a business that developed under very strong protective monopoly structure, almost territorial for a large part of this century, and so now suddenly we're saying, well, it isn't good any more because there isn't enough opportunity, but the one who's going to pay that price, in my view, is the individual customer, the consumer, the borrower, the ones who borrow money for the house, the one who borrows money to start a business. It's not going to cost the same low rate of interest that it used to. And again, that could be examined at length here and in other forums and come up with a view that it was or wasn't a very good one, but nevertheless, we have made a lot of progess in that mode.

The Mortgage Bankers Association is projecting a rise in the average mortgage rate to 14 to 15 percent by yearend, which is going to bring to a screeching halt the homebuilding market.

Do you agree that that's where we're going (a); and (b) that it will have that kind of an influence on the homebuilding industry or homebuilding opportunity?

Secretary **Regan**. Well, you're talking about interest rates. I think that interest rates are set by monetary policy.

Senator **Lautenberg**. Not by fiscal policy?

Secretary **Regan**. Fiscal policy indirectly, but primarily monetary policy, and this is not a function of the banks themselves. It's a function of the Federal Reserve that sets monetary policy, either supplying or withholding funds, and the demands on the system, and the supply of funds available. So whether or not we allow more competition in the banking business or allow the banks to compete more in other forms of business, I don't think has anything to do with whether or not interest rates will be higher or lower at a point in the future. I think they could be higher or lower regardless of what happens in this legislation.

Senator **Lautenberg**. Would you comment on whether or not that mortgage money as we used to know it is going to be available in the same proportion of our financial structure as it used to be?

Secretary **Regan**. I think even more mortgage money will be available, but at a price, of course.

Senator **Lautenberg**. Variable?

Secretary **Regan**. If rates go up, obviously there aren't going to be that many takers, even though the supply of money might be available. There's not going to be that demand for it at 14 or 15 percent. You and I both know that. But at lower rates, there will be a big demand and there will be a big supply of it. That's why we're talking about TIM's legislation and any number of other creative devices in order to have mortgage money available in this country.

Senator **Lautenberg**. At 15 percent, the cost of a house doubles in approximately less than 5 years, using the rule of 72. There is going to be mortgage money available, I agree with you, but there are going to be very few takers because it's going at competitive market rates, and when one has to put that much into housing, it's very difficult for the average income earner to get by.

There's also I think never really been a test yet of what the variable rate mortgage means to the individual when in fact interest rates move up because it's very easy to contemplate a payment schedule except when, Lord forbid, we're back at 15 or 18 percent base rates, and that's going to be devastating and I think we are going to see a lot of pain and suffering as a result of that.

So I do challenge your statement on mortgage funds availability. They are going to be available, but I don't think anybody is going to be able to afford them. And after we have been through a cycle when people have lost their homes because mortgages were foreclosed, I think we'll start to see a distance from the variable rate mortgages by consumers.

You said earlier on the States' rights issue that you were a States' rights person. Didn't you in testimony before this committee advocate a preemption of the State usury ceilings by the Federal Government?

Secretary **Regan**. I'm trying to recall my testimony. I believe I did.

Senator **Lautenberg**. I thought that you did.

Secretary **Regan**. Well, you understand in States' rights, my attitude is that we do, at a minimum, at the Federal level allow whatever we can to remain with the States, but where there is a compelling need to do something about State actions that are obviously harming many citizens, then I think the Federal Government has stepped in and should step in to override the States.

The **Chairman**. If I could just interject at this point, Senator, that provision I've supported, but also as another amendment to that, States were allowed 3 years to override the Federal Government's action.

The request on usury came primarily from the States, States like Arkansas who had a constitutional provision in their State constitution of 10 percent, and the request for these overrides came from States. There I felt, when it originated there, that there should be a standard provision which I have insisted upon always of giving State legislatures a 3-year ride, saying, "Hey, we disagree with that Federal preemption." So that was the provision the Secretary did support.

Senator **Lautenberg**. But, Jake, it does go back to the fact that sometimes we think Federal regulation is good and sometimes we think State regulation is good. We can't just blanket it out there and say, OK, this is the way it's going to be. Part of what I consider my responsibility here is to try to participate in developing legislation that treats as much of this as equitably as we can, and I think as we deregulate we're going to have in some forms reregulate to protect what I think has been—with all of its faults, with all of its problems—a pretty good system and one that benefited our society greatly.

ARGENTINE DEBT SITUATION

I want to just ask something else, Mr. Secretary. According to this morning's Post, Treasury is monitoring the Argentine debt situation, but you have no plans to bail out either the banks or the Argentine Government. Does the administration have any plans at all for handling this crisis that could develop into a crisis of significant proportion (a); and (b) is there a list of this spreading among other hard-pressed nations who say, "Look, our situation is even more difficult than Argentina and they're soft, let's hold back."

Secretary REGAN. Well, the Treasury has been doing an awful lot of work in this area with the Argentine Government. I talked to Mr. Bernardo Grinspun when he came up. He's the Minister of Economy. There has been a meeting over the past several days in Argentina with the Inter-American Development Bank and I have had both my Deputy and an Assistant Secretary of the Treasury down there for this particular purpose, talking to the other Finance Ministers, talking to the Argentine Finance Ministers, about this situation. I wrote a letter to the Argentine Finance Minister about it.

So we are trying our best to make them aware of their actions and work with them to see if there's any way to solve it. We've had communications with the IMF practically on a daily basis, and with the banking groups that are concerned. We're trying to avoid this situation if at all possible.

I did say, in answer to a question asked by Senator Riegle, that the statement in the New York Times this morning that I want to bend the rules is incorrect. I do not want to bend the rules in any way, shape, or fashion. But if there is any way of saving the situation, I would like to do it because they have a new Government in Argentina and it's a popularly elected Government. We'd like to see them succeed if at all possible. So we are offering our best efforts to try to resolve this situation, but whether or not we will be successful, I don't know.

Senator LAUTENBERG. Mr. Secretary, in the remainder of the question I talked about whether or not we had to be concerned about developing a soft reputation for debt collection, whether that would proliferate among other nations.

Secretary REGAN. I would certainly hope not, and it's not our intention that it should. After all, sovereign nations have to remember their responsibilities, and because there's a change of government you can't just duck what you have inherited from a previous administration. There's no turning away from that. Debts that have been legally incurred have to be honored or else there will be no banking system and no international trade. We'll have to go back to bartering.

So this is a very difficult thing for people to have to do. I've seen this in the case of Mexico. We've seen it in other cases. In the case of Mexico, which I applaud, the incoming Government respected the debt of its predecessor and has tried to solve the problem and is solving it, and that's the approach we urge in Argentina.

Senator **Lautenberg**. Thank you, Mr. Chairman.

The **Chairman**. Mr. Secretary, let me return to something Senator Hecht brought up some time ago and that was the issue of reciprocity and he was broader in terms of trade, but specifically looking at the banking situation, S. 2193 was introduced by myself, Senator Hawkins, Senator Hecht, and Senator Lautenberg. That is not coincidental that it happens those are on that particular bill, because we had the opportunity to travel together to Japan and also to Australia and look at the particular problems of those who close their markets to our financial institutions and yet operate relatively freely in our own country. And so that bill is still before the committee. I would hope to report that bill out some time during this year and I have requested an update on the national treatment study from Treasury and one of the reasons is that I have been waiting for that study. So when it's completed, we would appreciate the results of that study because I do think it's a very unfair situation internationally concerning the national treatment of other banks in this country compared to the national treatment that we get overseas.

I'm sure Senator Lautenberg and Senator Hecht would agree with that.

Senator **Heinz**. Senator Heinz would, too.

The **Chairman**. Senator Heinz would agree, too.

Secretary **Regan**. We have that study underway, Senator. We hope to have it to you some time in April. Hopefully by then we will be able to include in the study some new evidence of what is happening in Japan.

The **Chairman**. Nothing happens in Japan except they treat you very nicely, very politely, and as one who lived in Japan, I love the Japanese people, but their Government bothers me with all the politeness. You leave feeling you've accomplished something on trade but as soon as you get home you realize that you've accomplished nothing and they just patted you on the forehead and fanny and told you they were going to do something about it but they never do. So we share your frustrations in dealing with the Japanese. Maybe it's because they failed so miserably at Pearl Harbor that they've been making up for it ever since and didn't succeed in taking over the whole country at that time, but in their trade they've been much more successful.

Before I close the hearing, are there any more questions?

SHOULD BANKS/THRIFTS BE ALLOWED TO PURCHASE ONE ANOTHER?

Senator **Heinz**. One quick question. Mr. Secretary, when we talk about banks being allowed to, for example, purchase insurance companies, start mutual funds or purchase them and so forth, is there a reason why—while we're talking about banks doing all of these other financial services things—we don't talk about banks acquiring savings and loan associations, thrifts?

Secretary **Regan**. I know of no reason why we have or have not discussed it, Senator.

Senator **Heinz**. Those are deposit taking institutions. They are very much like banks. Is the Treasury in favor of this legislation including bank acquisitions of thrifts of thrift acquisition of banks?

Secretary **Regan**. I want to make sure that it is in the bill now and we do support it.

Senator **Heinz**. Beg pardon?

Secretary **Regan**. It is in the bill now and we do support it.

Senator **Heinz**. Banks would be allowed to acquire thrifts and thrifts would be allowed to acquire banks?

Secretary **Regan**. Yes, whether they're failing or not. As you know, they are allowed to do it now if they are failing institutions. Citicorp, for example, has done it in three States.

Senator **Heinz**. People in Illinois are well aware of that. Thank you, Mr. Secretary.

The **Chairman**. Senator Lautenberg.

Senator **Lautenberg**. Thank you, Mr. Chairman.

Mr. Regan, I wanted to be sure that I understood your view and this morning as I listened to it I wasn't sure that you were talking about the nonbanks coming into the banking business to be reciprocated with the banks getting into other business as being the primary reason for nonbanks getting into the banking business. I'm confused. Let me just straighten that out.

I heard you say that divestiture removal, nonentry by nonbanks into the banking business would be OK. I don't want to put words in your mouth but I'm giving you my interpretation. It would be OK if the banks were allowed more powers. Is the reversal true, also; that is, if the banks were not allowed more powers, that you would support the nonbank intervention into the banking industry?

Secretary **Regan**. No. I think that if you're not going to allow the banks into these other areas you will have to take a step backwards, which would be to prohibit these other institutions from getting into any other business.

Senator **Lautenberg**. So your preferred view, if you would articulate it just once more, is it be permitted to flow both ways?

Secretary **Regan**. That there be free entry into any area of financial services by any financial institution. That is, an insurance company going into the brokerage business, a bank going into the insurance business.

Senator **Lautenberg**. Retailer?

Secretary **Regan**. Either way.

Senator **Lautenberg**. You used the definition of "financial institution," and it would clear the air very quickly if you would use retailer as an example.

Secretary **Regan**. Well, I hadn't focused on that, but the Garn bill and the legislation we introduced would only permit financial institutions into that type of business as a bank holding company.

Senator **Lautenberg**. So you wouldn't restrict it then to a financial institution. You're saying to let it flow both ways freely?

Secretary **Regan**. No, It should flow freely both ways only for banks and other financial service organizations.

Senator **Lautenberg**. Thank you.

The **Chairman**. Mr. Secretary, today marks the 10th and the final day of our hearings on S. 2181. We have heard from over 55 witnesses in this particular series on S. 2181 and S. 2134, and various trade and consumer groups, from individuals, from State and Federal agencies, and these witnesses have supported, criticized, condemned, analyzed, discussed, and cussed the general thrust and specifics of S. 2181 and S. 2134 and other relevant proposals.

I believe we have added to the massive amount of information we have had on these issues in previous hearings over the last several years and I believe we certainly have the basis of information for moving ahead.

Let me close the hearings the way I started them, with an open mind. Initially people were always talking about poor bills and packages and what we would delete and what we would add and what we might finally end up with. And I may be unusual in Washington, but I have tried the whole 10 years I've been here to mean exactly what I say and nothing else and no hidden agendas or meetings.

I continue to hear rumors that there is a package. There is no package. There has not even been any discussion about a package. I said we would hold these hearings and it was inappropriate to do so until all the witnesses had their opportunity to testify; otherwise the hearings just became a sham and charade like, unfortunately, too many are in Congress, for the purpose I suppose of getting people on TV and the newspaper more than the substance of the hearing.

NO PACKAGE—OPEN MIND

But I meant what I said then and there is still an open mind. I have even heard some comments from some of my colleagues on the committee that they have not been part of the process. Well, if they have not been part of the process, that is not my fault. We have held 10 hearings and they have been notified of each and every one. And don't misunderstand my comments, I, as well as any other Senator, recognize the conflicts. There was one this morning. There was a briefing on El Salvador that started at exactly the same time and I know they serve on other committees. So I'm well aware of why.

But nevertheless, what I want to point out is not criticism because they have not been here, only to point out that I understand why not, but this has been the only game in town, the open public hearings, as they should be. There have been no discussions on a package. I have held no meetings and I have had no negotiations and I meant exactly what I said—we would hold the hearings, openly, everybody could testify who desired to do so and I think everybody would agree that the hearings have represented every viewpoint possible on these subjects. Many people say both sides. There have been a lot more than two sides.

Now the time has come to review the material and I certainly agree with the comments that have been made—I could hardly disagree with those who now say we should push to a markup. I would have liked 1 a year ago, last fall. To those who wanted a 6-month moratorium, 9 months have passed. They got their 6 months and 3 months more has gone by, proving to me that that was just an excuse for delay.

So we will hold the markup and I've even heard that I've already set the date. That is not true either. I'm amazed at what I hear I have done that I have not done, and I will not set a date until we are ready to hold a markup. The staff will now go through and we will talk about what is possible and what is not possible and we will have discussions informally among committee members so that they can have their input, particularly for those who feel they have not been part of the process. That's why I wanted to emphasize there has been no process except the open public hearings. They have missed nothing except the open public hearings and if any members of the committee on either side of the aisle have suggestions they wish to make after going through the committee records themselves, certainly we are now in that process of reviewing all of the material, considering all the suggestions which have been made and deciding what an approximate package should look like, and that includes suggestions from members of this committee as well, and we will proceed to a markup as soon as it is possible to do so, when we are prepared to go to a markup.

It is clear that we need to act as expeditiously as possible. I have said that all year long. But I also will not go into a markup half done and unprepared to do so. So I will continue, as I've said many times before, to try and accomplish a banking bill this year. Because of your three alternatives, I think that is the only responsible way to go. Divestiture is not a good way to go. Doing nothing is not a good way to go. I certainly will try and move Congress, if it is humanly possible for me to do so, and I appreciate your work on this, Mr. Secretary. I used you as an example for a whole industry and we have had enough talks over the years that I could tell you're not offended. You knew where I was coming from and what I was trying to illustrate.

On the other hand, I want you to know how much I respect those who repent. Over the last 3 or 4 years you have been personally—not just your Department—but incredibly helpful and personally involved throughout the entire process. Garn-St Germain would not have been possible without your personal help. This bill will not be possible without your personal help and I do very much appreciate your continued work and effort in this process of trying to rationalize the financial services industry. I particularly appreciate your patience today after—your body is in China or wherever it is, I don't know—but you were once again a very good witness and we appreciate that. Thank you very much.

Senator LAUTENBERG. Mr. Chairman, before you close, I would have to confirm what you said about the fact that there has been adequate invitation and openness in terms of hearing and developing the information. If I may just tell you on the record that you're not unique in meaning what you say. There is one other Member of the U.S. Senate who means what he says. We'll just have to figure out who that is. [Laughter.]

The CHAIRMAN. The committee is adjourned.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

QUESTIONS SUBMITTED BY SENATOR RIEGLE AND CHAIRMAN VOLCKER'S RESPONSES FOR INCLUSION IN THE RECORD OF THE HEARING BEFORE THE SENATE BANKING COMMITTEE ON MARCH 27, 1984

1. It my understanding that the Securities and Exchange Commission has been devoting a considerable amount of its enforcement effort to investigating and prosecuting companies and managers who sent false financial reports to their shareholders. Glenn Perry, the man largely responsible for this operation at the Commission was quoted in the New York Times as saying that among the Commission's recent book-fudging targets are banks. "Last fall we selected banks as a program priority because of the abuses we saw on the loan loss area -- providing for bad or questionable loans. So we've brought two cases involving loan loss provisions, and we're currently investigating a number of other banks." Is the Federal Reserve Board cooperating with the SEC in these investigations and how serious a problem are we talking about?

Response: The SEC has on occasion contacted us with respect to specific banks or bank holding companies. Generally, the SEC requests information from a Report of Inspection of a bank holding company or a Report of Examination of a State member bank; and, when there is information relevant to the SEC's inquiry in a Report, we make the specific portions of the Report available to the SEC's staff.

The federal bank regulatory agencies are, of course, primarily concerned with bank data reporting systems and with the maintenance of standards and policies that provide adequate disclosure and assure a safe and sound banking system. We are not aware of any general problem with respect to reporting of loan losses, but continue to follow individual bank situations to maintain compliance. In fact, the adequacy of loan loss reserves and the public reporting of information relating to such reserves have been the subject of several formal enforcement actions undertaken against State member banks and bank holding companies by the Board of Governors pursuant to the Financial Institutional Supervisory Act of 1966, as amended. With respect to the SEC's current focus on financial statements issued by banks and bank holding companies and their related reporting of loan loss provisions, the SEC has not, to date, contacted Board staff regarding this matter.

2. In the past, you have expressed serious concerns about the concentration of financial resources that could result from unrestricted mingling of banking and commercial concerns. How serious is your concern about such potential concentration?

Response: The prevention of the concentration of financial resources is one of the basic purposes of the Bank Holding Company Act. This purpose is accomplished by requiring prior Board approval of bank acquisitions, by prohibiting outright the affiliation of banking organizations with most nonbanking concerns, and by requiring the Board to consider the potential that a concentration of resources may develop as a result of the acquisition of companies engaged in activities that are closely related to banking under section 4(c)(8) of the Act. These important public policy concerns are seriously undermined to the extent that the nonbank bank device can be used as a vehicle to mix banking with general commerce, and nonbank banks already have been acquired by large commercial, retail, insurance and securities firms. I believe that the need for Congress to address the problems created by nonbank banks with regard to the concentration of financial resources and the uncontrolled combination of banking and commercial firms is urgent, because the use of nonbank banks to avoid the Bank Holding Company Act's provisions is becoming rapidly more widespread.

3. What is your reaction to the decision of the Tenth Circuit in the "Beehive" case? What are the serious implications this case has on the structure of the financial industry?

Response: If the decision of the Tenth Circuit Court of Appeals that NOW accounts are not demand deposits is not altered, the nonbank bank loophole will be greatly expanded.

Both banking and nonbanking organizations would be able to acquire nationwide chains of national banks that offer NOW accounts, make commercial loans, and provide a full range of banking services.

4. What reaction would you like to see from the Congress and why? If, in fact, it is finally determined that a "NOW account" differs legally as well as in form from a "demand deposit", what adjustments, if any do you believe are necessary in defining what is a bank?

Response: If the Beehive decision stands this will make even more acute the need for Congress to act promptly to enact a revised definition of the term bank for purposes of the Bank Holding Company Act along the lines that we have suggested. The bank definition that we have proposed would be sufficient to deal with the additional problems caused by the Beehive decision, and no modification of that definition would be necessary.

5. Some analysts are beginning to question how much further banking deregulation should go and are expressing concerns that in this era of increased financial institution competition, moderate and lower income people and areas are not being provided basic banking services at low cost, and, in

fact, are being squeezed out. What is your reaction to these assertions and to suggestions that maybe banks should provide more of a public utility service?

Response: Deregulation, particularly the deregulation of interest rates paid to depositors, has resulted in a narrowing of profit margins from intermediation for many of the Nation's banks. In an effort to offset these narrower margins and maintain profitability, banks have, to an ever increasing degree, begun to explicitly price banking services that were previously subsidized by savers. Explicit pricing of banking services is reflected as increased charges for checking accounts, check cashing, and money orders as well as the institution of minimum balance requirements for deposit accounts, etc. These actions have undoubtedly raised the prices for banking services for bank customers including low and moderate income customers. Although there have been these increases in prices, the banks, of course, continue to have a unique public interest responsibility given the degree of Government support they enjoy. This public interest responsibility is embodied in laws such as the Community Reinvestment Act. This approach allows flexibility for banking institutions to meet the needs of their customers while assuring that public interest considerations, and particularly local needs, are taken into account in bank decision-making.

6. On March 3, 1983, Dimension Financial Corporation (Dimension) a Delaware Corporation headquartered in Denver, Colorado, filed 31 applications for de novo national bank charters with the Office of the Comptroller of the Currency. These Dimension national banks were proposed to be located in 25 separate states. I gather that the Federal Reserve Board and the Comptroller's Office take opposing views on this application. From your prospective, what are the issues at stake in this application? How would you have Congress address them?

Response: The principal issue raised by the Dimension application is whether the nonbank bank device can be used to set up a nationwide deposit taking organization despite the interstate banking prohibitions contained in the McFadden Act and section 3(d) of the Bank Holding Company Act. The Board has done all it can to expand the existing bank definition in the Bank Holding Company Act in order to prevent the undermining of section 3(d) that would be caused by the approval of such an application. Dimension may be able to operate its proposed nationwide network of banks in a manner that is in technical compliance with the bank definition but nevertheless frustrates the policy and spirit of existing interstate banking prohibitions. The bank definition that we have proposed that Congress enact is intended to resolve the issues raised by the Dimension application, and as we have indicated, we hope that Congress will act promptly on our proposed bank definition.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

June 22, 1984

Honorable Jake Garn
Chairman
Committee on Banking Housing
  and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

This letter urges you to consider the benefits to small business of reduced regulation of the financial services industry. Bank deregulation is an important move, giving rise to much concern by small business owners. Nevertheless, I believe that we need to use the opportunities offered by less regulation to improve the credit environment for small business.

The Office of Advocacy was created in 1976 to speak out for reduced regulatory burdens and costs for small businesses and to represent the views and interests of small business before federal agencies and the Congress.

The dramatic changes occurring in the financial services industry have been well documented. It is important that this attention not obscure the importance and needs of our Nation's 14 million small businesses and small financial institutions. This letter will focus on the concerns of small businesses and small banks within the new and uncertain deregulatory environment of the financial services industry.

SMALL BUSINESS FINANCING IN A CHANGING FINANCIAL ENVIRONMENT

Our primary concern regarding small business financing is access to capital at competitive rates. The success of small business is dependent upon access to both equity investment and credit from financial institutions operating in efficient capital markets. Small businesses, as well as large, need to scrutinize and understand the new financial marketplace.

Banks are important sources of small business credit and capital, providing operating capital through inventory and receivables financing, real estate financing, and intermediate term loans for equipment. Overall, small firms owe 20 to 30 percent of their total financial liabilities to banks.[1]

Small corporations use about $85 billion annually to purchase assets necessary for their businesses. While over half these funds are generated by depreciation and retained earnings, trade credit and short-term debt was the source for an important 25 percent of the funds raised by small corporations between 1978-1980.[2] Large corporations have a similar reliance on trade credit and short-term debt, but use long-term debt twice as much as small firms.

Because small firms depend more heavily on short-term credit than large firms and because small firms have higher debt/equity ratios, small firms are particularly sensitive to interest rate fluctuations. The stability of credit markets and access to them are consequently of deep concern to small business.

Nonbank lenders are becoming increasingly important to small business borrowers. One measure of this is found in SBA's own guaranteed loan program. In 1980, all of the top 15 lenders out of the 11,000 participants in the SBA's 7(a) loan guarantee program were commercial banks. In 1983, the list of the top 15 included two savings and loans associations and three non-depository financial institutions.[3]

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[1] The share of credit market funds advanced by commercial banks, relative to that advanced by other private financial institutions (one-fifth) probably underrepresents the importance of banks in meeting small business credit needs. See Federal Reserve Board, Flow of Funds Account, Third Quarter, 1982.

[2] The State of Small Business: A Report of the President, Small Business Administration, Office of Advocacy, 1984.

[3] The SBA program is an important component of small business credit particularly for intermediate and long-term financing. In Fiscal Year 1983, this program provided $2.6 billion in credit guarantees to banks and other financial institutions extending small business credit. The total value of outstanding guarantees is $7.2 billion.

Other sources of small business credit in addition to banks, savings and loan associations and trade credit include finance, leasing and factoring companies, and loans from shareholders.

This picture of small business credit has developed in a highly regulated environment, both at the state level and nationally. Despite pervasive regulations for key players in the financial services industry (banks, savings and loan associations, retailers, insurance companies, and securities firms), changes are occurring rapidly in financial markets. In 1980, Congress acted to accommodate the banking regulatory scheme to these changes through phased elimination of interest rate ceilings on deposits. In 1982, Congress acted to allow all depositories to compete with money market mutual funds and permit expanded commercial lending powers for savings and loans associations and mutual savings banks. The states, as well, have begun to allow banks to do what the federal government has traditionally prohibited them from doing. The reciprocal interstate branching bills are an example.

Future decisions to be made by federal and state governments and regulators of financial service providers are important to small business owners since these decisions can hasten or delay the pace of beneficial developments in financial services markets and can alter the structure of the industry that provides such a key commodity - credit to small firms.

A. Impact of Deregulation on Small Business Borrowers

Proposals currently before Congress focus on the expansion of bank services. Nevertheless, I believe that events will soon overtake restrictive geographic and product regulation as financial service companies find ways to serve new markets.

Reduced regulation of banks offers a host of opportunities and risks for small business owners. There are, however, three main concerns repeatedly expressed by small business owners: 1) whether local lenders will continue to exist; 2) whether credit will be affordable; and 3) whether credit will be provided in a competitive market.

I would like to discuss all three areas of small business concern, even though particular bills being considered may not at this time provide for the degree of deregulation possible or likely over the years.

1. Will local financing sources continue to exist and make small business loans?

While there may well be, and has already been, significant consolidation in the financial services industry, small local banks can and will survive under less regulation in the future. There is also evidence that the number of new banks being established has been increasing over the years.

NEW BANKS

YEAR	ALL NEW BANKS	INSURED BANKS
1978	178	148
1979	233	204
1980	241	205
1981	250	199
1982	373	317

SOURCE: FDIC DATA

Small, local banks are important, especially in rural areas where they are often partners in many small businesses. They provide financial advice and are able to extend credit to their local clients more knowledgeably than out-of-town banks.

Some small business owners and small bankers fear that increased competition from out-of-state banks and merger activity will result in fewer and larger banks, controlled from the big money centers and uninvolved in local communities. However, New York City banks have been allowed for several years to expand into upstate New York and small banks have continued to compete and survive quite well.[4] The familiarity of the community bank with local customers and the role of a local board of directors give community banks competitive advantages over large "outside" institutions.

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[4] "The New England Experiment in Interstate Banking;" Richard Stynan, The New England Economic Review, March/April 1984.

New banks opening in Connecticut are betting that larger banks created by mergers will ignore small business customers[5] and they intend to fill the void. A state experiment underway in Connecticut permits banks in Massachusetts and Rhode Island to merge across state lines. Despite possible competition from large existing institutions, two new banks have recently opened and the state banking commission believes an additional eight may be approved by June.

Small business borrowers themselves are increasingly turning to out-of-state credit sources for alternative financing. A recent Florida A&M study found that Florida business borrowers were as likely to borrow out-of-state as from in-state banks.[6]

In short, local and national financing alternatives will exist for small business as the range of opportunities continues to expand. To remain competitive in their own industries, small firms will have to seek out the best financial service products and prices from whatever source. Small firms will need to be as creative in managing their financial affairs as they are in managing other aspects of their business.

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[5] Wall Street Journal, March 27, 1984, p. 2.

[6] "Florida A & M University, Larry A. Frieder, The Southern Financial Marketplace: The Florida Interstate Banking Study, 1984.

2. Will credit be affordable?

In the not too recent past some community banks were able to provide small business credit below money center rates. They did this by taking money in at regulated rates, a little over 5 percent, and loaning it out at a higher rate that was still below money center rates. Community banks are now competing for deposits with other banks all over the country and with money market mutual funds and other investment vehicles, and their costs have risen accordingly. To the extent that local depositors subsidized local commercial lending, less regulation and a more sophisticated saving public in search of high yields has resulted in increased borrowing costs for some small firms. No bank any longer has this cost advantage of a generous yield spread between passbook deposits and national money rates.

For the small business borrower the newly competitive market which may be more complicated has several offsetting advantages. First, deposits of consumers and small business owners can now earn competitive returns either in a brokerage firm's cash management account or through money market funds offered by banks and other depositories. On the borrowing side the small business can now look to a variety of competitive sources: savings and loans (who can now loan up to 10 percent of their assets for commercial purposes), non-bank (heretofore, non-depository) lenders and others who are unfettered by geographic or product restraints and are providing both new and traditional banking services on an interstate basis.

Deregulation has given birth to innovative financing techniques encouraging more money flows into the capital markets. These changes may be particularly beneficial to small business.

With expanded securities and insurance powers, banks could provide more long-term capital to small businesses by developing loan or equity participation for large investors. Banks could also package and privately insure small business loans as mutual funds.[7]

Recently, one New York City bond insurance underwriter also found a way to provide below prime rate, short-term cash to small firms through the commercial paper market. Through proposed commercial paper default insurance, small but creditworthy companies with annual sales of less than $10 million would be able to issue unsecured commercial paper (or promissory notes) just as large corporations do. Although limited to a very small number of small businesses, it would allow them to tap into a $180 billion commercial paper market and save from one to three percentage points along the way. Since a lot of small banks have lending limits of less than $2 million, the advent of a small issuer commercial paper market could help these banks hold on to growing customers.

3. Will small business owners have access to competitive credit markets?

   Beyond the rates charged for credit, small firms are concerned that consolidation in the banking industry will subject them to oligopolistic markets for a wide variety of financial services. However, the following chart from the April 1984 Economic Review of the Federal Reserve Bank of Atlanta provides dramatic evidence that this concern may be over-stated. Competition should make more services available to small businesses and households.

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[7] Comments of Doyle L. Arnold Sr., Deputy Comptroller for Policy and Planning, Office of the Comptroller of the Currency. Washington Financial Reports, Vol. 42, p. 144.

In a comparison of the different financial services offered by different types of institutions in 1960 and then in 1984, the explosion of new offerings is graphically evident, with notable growth in the breadth of services in the non-bank areas. Savings and loan associations, insurance companies, retailers and securities dealers have added a considerable number of traditional banking services to their menus.

Chart 1. Financial Services
1960 and 1984

	Banks		Savings & Loans		Insurance Companies		Retailers		Security Dealers	
	1960	1984	1960	1984	1960	1984	1960	1984	1960	1984
Checking	★	★		★		★		★		★
Saving	★	★	★	★		★		★		★
Time Deposits	★	★	★	★		★		★		★
Installment Loans	★	★		★		★		★		★
Business Loans	★	★	★	★		★		★		★
Mortgage Loans	★	★	★	★		★		★		★
Credit Cards		★		★		★	★	★		★
Insurance					★	★		★		★
Stocks, Bonds, Brokerage		★		★		★		★	★	★
Underwriting									★	★
Mutual Funds						★		★	★	★
Real Estate				★		★		★		★
Interstate Facilities		★		★		★		★		★

Source:
Federal Reserve Bank of Atlanta, Economic Review, April 1984, p.26.

B. Small Banks in Less Regulated Markets

Small banks face new challenges as well in less regulated markets. The integration of product and service markets that is occurring as barriers to entry are reduced, eliminated or circumvented is placing new and intense pressure on managers of small banks. Many whom I have spoken with welcome it. Like other small business owners, small bankers will survive and prosper to the extent that they pay better attention to customer needs and to quality service.

This does not necessarily mean offering a wide variety of services, although some entrepreneurs may choose that route. Successful market niches offer large opportunities for bankers situated to take advantage of particular expertise or focus.

Those seeking to provide a broad range of services may need to consider alternative means of delivery. Contractual or cooperative arrangements with providers of insurance, real estate, or securities may enable small bankers to provide full services to customers in competition with large banks or retailers involved in the financial services supermarket. The small bank should at least have the option to choose the product markets it will serve; most of its competitors and large banks already enjoy this advantage. More alternatives may be their only hope of remaining competitive with less regulated institutions in the future.

1. Ability of small banks to compete for deposits.

Increased competition places new importance on managing bank costs. Interest rate deregulation has allowed banks and thrift institutions to attract back to their accounts huge amounts of money lost to money market funds when bank interest rates were regulated. This increased cost assures banks of access to funds but squeezes profits significantly. Well managed banks will survive such a squeeze, others will not.

Increased access to new technologies, new product development, alternative capital markets and a lean, competent workforce are all important assets which smaller banks seek to master in a competitive environment.

2. Need for even-handed and reduced regulation for small banks

In banking as in other industries, state and Federal regulation can impose great and disproportionate burdens on smaller competitors. In the banking industry these regulations include capital regulations, bank examination criteria and restrictions on geographic and product market extensions.

We have participated extensively in the Vice President's Task Group on Regulation of Financial Services and before different financial regulatory agencies on several regulatory issues. As regulations are reduced, it is essential that those that remain do not restrict the ability of smaller firms - be they banks, savings and loan associations or others - to take advantage of new powers. A local bank newly permitted to offer a new instrument to better compete with a large retailer or a money center bank can hardly do so if it is subject to more stringent capital asset ratio regulations than its competitors.

Bank examination guidelines that unfairly downgrade bank portfolios with large investments in small business loans need to be reviewed so that small banks are not handicapped at the starting gate by unequal regulation. Classifying loans made by aggressive lenders to small and growing businesses as especially risky is unjustified.

The primary cause of bank failure is fraud, self-dealing and poor management. To the extent that failed banks tend to be located in small towns, they seem also to be located in areas hardest hit by economic downturns, where the inability to diversify geographic or product markets increases risks associated with local economic factors.[8]

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[8] Interview with John Downey, Bank Examiner for the Office of the Comptroller of the Currency. Washington Financial Reports. January 16, 1984., p. 163.

Overall, however, small banks with small business portfolios are quite often very profitable and no more risky than larger banks.[9]

Related Small Business and Small Bank Research

Advocacy has developed research over the years which reflects the significance of small banks and other financial institutions to the local financing needs of small firms and investigates small business capital formation problems. Appendix A summarizes this research.

Conclusion

Deregulation produces structural change, at times quite abruptly, that tends to be accompanied by uncertainty. Most of us operate more comfortably in an environment of structural stability and certainty. Change and uncertainty require greater effort and, while they may also produce greater gains for some, they produce losses for others.

We have found that smaller financial institutions do a good job of providing credit to the small business community. But these institutions must adapt rapidly to survive in more competitive markets. I believe that small business borrowers will be well served by a more competitive environment; this is the source of my previously stated concerns for equitable bank capital regulations, evenhanded antitrust policies, and regulatory structure for the financial services industry that provides realistic competitive opportunities for small financial institutions and their small firm clients. I do not think we can stop the clock on competition in financial services markets nor that we should.

Yours very truly,

Frank S. Swain
Chief Counsel for Advocacy

Enclosures

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[9] James W. Kolari and Donald R. Fraser, "Size and Financial Performance in Banking." Texas A & M University, (Washington, D. C., report prepared for the Office of Advocacy, SBA under Contract No. SB-1-A-00072-01-1, October 1983).

APPENDIX A

SUMMARY OF RESEARCH COMMISSIONED BY ADVOCACY

Completed Research:

1. The Role of the Financial Institutions of a Community in the Formation, Effectiveness, and Expansion of Innovating Companies by Albert Shapero.

   Summary: The research studies the role of financial institutions at the community level in the formation, growth, and effectiveness of innovating companies with a view to developing a body of knowledge to aid those responsible for developing relevant and feasible policy programs and options. The research studies the financing of new ventures in a community with a view to measuring the propensity for financing innovative small companies in different communities.

2. Capital Markets Servicing Small Business: Implications of the Rapid Evaluation of the Financial Services Industry Irving Levenson and Hudson Institute.

   Summary: The study examines major changes taking place in capital markets and in the financial services industry and determines their significance to small business financing. Leveson concludes that (1) Changes in the nature of the financial services industry will impact positively and negatively on small business, but there is no reason to believe that the overall impact will be detrimental to this group. (2) Deregulation of the financial institutions will increase competition and lead to opportunities for improvement in the cost and availability of services for small business. While some firms may cease to serve small business, others may specialize in meeting their needs. (3) Public policy should continue to foster the innovation and deregulation in financial services that is now occurring, since these improvements may help small business. This includes supporting the Federal Home Loan Bank Board's efforts to give thrift institutions the broader powers of commercial lending, factoring, and lease financing.

3. Effects of Size on Bank's Performance. James Kolari and Don Frazer, Texas A & M University.

   Summary: There is little available information on the ability of small banks to remain viable entities and effectively serve the needs of small business under new deregulation activity. The Office of Advocacy commissioned research to examine costs to both small and large depository institutions of offering money market mutual funds and super-NOW accounts under interest rate deregulation. Preliminary results indicate that smaller rural banks may be less affected by intense competition for deposits than previously assumed, and that NOW accounts, especially the super-NOWs are not likely to significantly erode small bank financial viability. The study suggests that disintermediation from smaller banks to larger banks, or to money market funds, may not occur to the extent expected. Instead, evidence shows that deposits will flow from money market funds to the banks, at least initially. Unfortunately, the largest banks are most able to offer high deposit rates on the new accounts and may benefit the most by them. This may tend to increase size disparities in banking.

The major impact of new instruments and higher cost money may be that banks will require both higher returns and more flexible terms of agreement on loans to hedge greater interest rate sensitivity. In turn, these trends will raise the cost of debt to small businesses in the United States.

4. Cyclical Dynamics of the Small Business Community by William C. Dunkelberg, Purdue Research Foundation.

Status: Phase I received (unreleased conclusions).

Summary of Phase I preliminary DRAFT conclusions: The study examines key issues in the financing, investment and credit behavior of small businesses by using the quarterly National Federation of Independent Business (NFIB) data base

- Small businesses place a high value on lending officers' knowledge of their businesses;
- The single most valued characteristic of the small business-bank relationship was "know you and your business;"
- The frequent small-business borrowers who ranked banks performance as generally good gave them the best ratings in the following characteristics: convenient location, wide range of services, easy access to bank personnel, one person handles credit needs, and reliable source of credit;

- The average interest rate on short-term commercial and industrial loans increased with: loan size, collateralized loans, loans to manufacturing construction and wholesale firms, loans to newer or rapidly growing firms, population size of market, loans made by city and metropolitan banks and loans made by banks in the New England and Pacific Regions, wages, and rates of 3-month Treasury bills;
- NFIB membership responses in 1980 and 1982 do not support a case for allocation of more credit to the small business sector: There is no strong evidence that small businesses receive better service in areas with statewide branching.

5. Two Studies in the Regulation of Small Issues of Securities and Their Investors by A. E. Osborne Associates.

   Summary: One study supports the need for greater size definitions in exemptions from reporting requirements and recommends that SEC increase the threshold for firms reporting under the securities laws from the current $3 million in assets and more than the 500 shareholder maximum test up to at least $10 million in assets/revenues.

   The second study addresses the SEC's reporting classification system which is based upon the level of assets. It is recommended that alternative criteria such as the number of shareholders, market value of the firm or of individual shareholdings, or trading volume would have a more relevant measurement tool for determining those firms which should meet reporting standards. The dollar investment of small businesses reporting to the SEC is inconsequential when compared to the total investment in the United States capital markets. The benefits afforded by mandatory disclosure for these small companies are inconsequential, whether measured in terms of number of shareholders, market values, or liquidity.

6. An Analysis of Regional Venture Capital Investment Activity and Venture Capital Investment In Need Areas by Norman D. Fast and Stanley E. Pratt, Venture Economics Division, Capital Publishing Corporation.

   Summary: These studies use the Venture Economics proprietary data base of financing information to discern the impact of venture capital investment on regional economic development during 1980 and 1981, and document venture investment activity in national need areas for the 10-year period of 1970 - 1980. Regional patterns of venture capital investment are identified.

7. The Securities and Exchange Commission and the Small Business Administration's Office of Advocacy. Phase I Initial Public Offerings of Common Stock: The Role of Regional Broker-Dealers in the Capital Formation Process and Phase II The Role of Regional Broker-Dealers in the Capital Formation Process: Underwriting, Market-Making and Securities Research Activities.

   Summary: The purpose of Phase I of the study was to examine the role of regional broker dealers in assisting corporations to offer their stock to the public for the first time. Phase II examined the underwriting, market-making and securities research support which national and regional broker-dealers provide to issuers of initial public offerings. Research showed that: (a) small and high-technology companies depend overwhelmingly on regional securities firms for initial efforts to raise growth capital in the public securities markets; (b) regional-broker dealers managed 92 percent of all initial public offerings of securities among companies with less than $10 million in annual revenue; and c) regional broker-dealers were found to be the leading market makers providing secondary market liquidity following the initial public offerings of securities of smaller companies.

8. The Impact of the Proposed National Market System on Small and Medium Sized Firms, by Sidney Robbins of Columbia University.

   Summary: This report, part of a 1970 FTC Interagency Agreement, discusses the lack of liquidity for small equity issues and the ways in which an electronic National Market System (NMS) could bring liquidity to equity issues by small businesses. There are some 20,000+ small business issues only quoted through the Pink Sheets, and automation would include benefits such as easier primary and secondary offerings, the ability of principals to market large blocks and valuation of the company for both straight debt and convertible bonds.

Proposed Research:

1. Small Banks in a Changing Financial Environment. There is a continuous concern about the future of small banks in the American economy in the face of ever-changing environment of technological advancement and financial deregulation. Questions frequently asked are, Will they survive? What can they do to assure their survival--networking, cooperative ventures, franchising, boutique banking, or joining the crowd in supermarket banking? The objective of this study is to extend existing completed research to provide an in-depth investigation of major management and financial issues faced by small banks in a new environment.